

# **ENTITY-LEVEL CONTROLS WHISTLEBLOWING SYSTEMS AND CODES OF ETHICS**

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# Entity – Level Controls

- **Assessment of entity–level controls is a fundamental component of Management’s Assessment of Internal Control Over Financial Reporting**
- **PCAOB Auditing Std. 2 (paras 52 and 53):**
  - ❖ **Identifying Company-Level Controls.** Controls that exist at the company-level often have a pervasive impact on controls at the process, transaction, or application level. For that reason, as a practical consideration, it may be appropriate for the auditor to test and evaluate the design effectiveness of company-level controls first
    - In practice, however, people have been doing it the other way around as have to cover a large % of “significant accounts” – this then gives you the “backbone” to find hooks for company-level controls to operate against

# Entity – Level Controls

- **PCAOB Auditing Std. 2 (paras 52 and 53):**

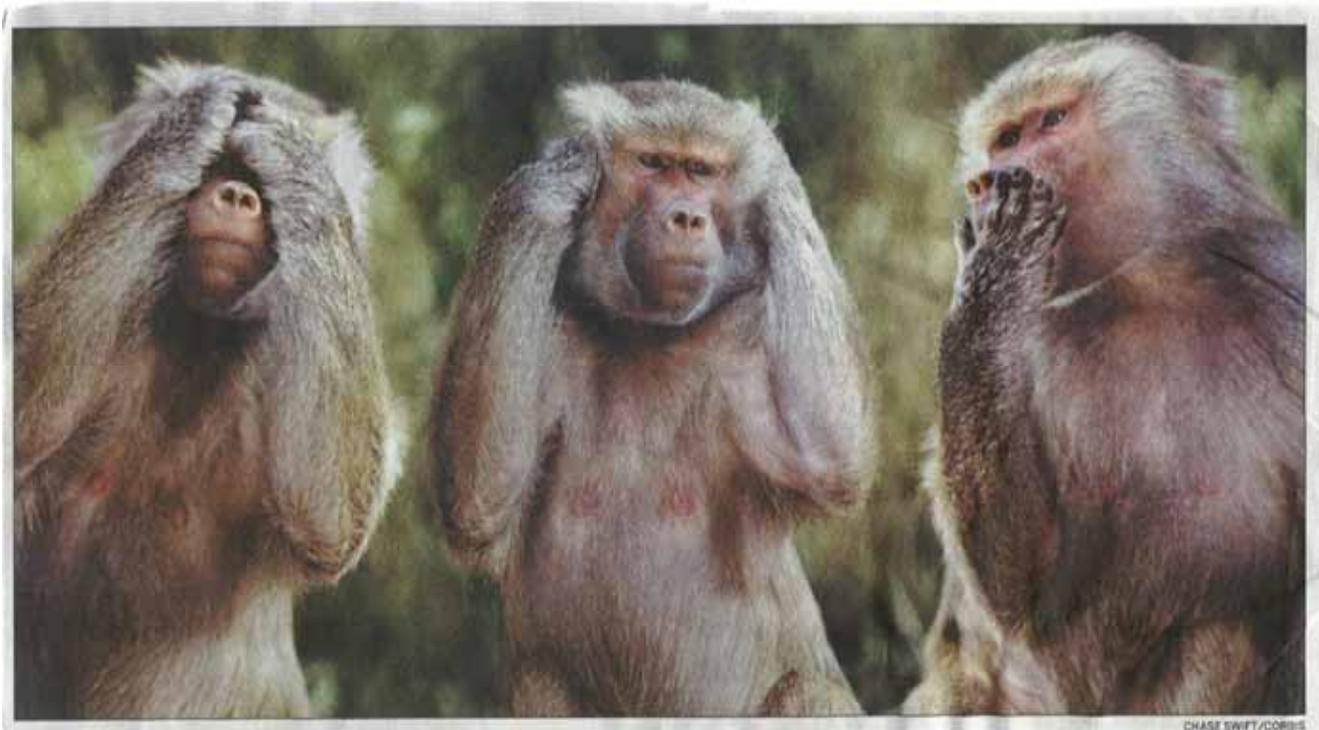
- ❖ Company level controls are controls such as the following: *[not an exclusive list]*

- Controls within the control environment, including tone at the top, assignment of authority and responsibility, consistent policies and procedures, programmes for codes of conduct and fraud prevention
- Management's risk assessment process
- Centralized processing and controls
- Controls to monitor results of operations
- Activities of the Internal Audit function, the Audit Committee and self-assessment
- Period-end financial reporting process; and
- Board-approved policies that address control and risk management practices

# Entity-Level Controls

- **Complete documentation of entity-level controls is just as important as consistent robust documentation for transactional or process controls**
- **Documentation of test plans and test results is also critical to ensure that to the extent possible tests are reperformable**
- **Each COSO component should be tested at the entity-level, which is hard to do**
  - ❖ COSO doesn't get granular re "behaviour"
  - ❖ Inquiry is not sufficient
    - Corroborative "structured" inquiry supported by examination, observation and reperformance may be OK
  - ❖ Controls on which other significant controls depend should be tested more extensively
  - ❖ Documentation of testing is as important as for process controls
  - ❖ Roll-forward of testing is also important if testing completed well prior to year-end
  - ❖ Hard to quantify/classify entity-level deficiencies

# The Goal of a Whistleblowing System is to Avoid .....



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"I Know Nothing; I See Nothing And I Say Nothing"



(double-click the symbol for sound playback)

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# Perspectives

- Edmund Burke's famous quote: *"Evil flourishes when good men do nothing"*
- Jeffrey Immelt (CEO of GE) in 2002 letter to stakeholders: "There are no sets of laws or rules that can stop a bad culture."
- T.S. Eliot's quote: "It is impossible to design a system so perfect that no one needs to be good."
- USSC Justice Brandeis: "Sunlight is the best disinfectant"
- Lynn Brewer (former Enron executive and whistleblower and author of *"House of Cards: Confessions of a Former Enron Executive"*):
  - ❖ "The truth is that Enron's failure was caused by two factors:
    - Contribution to the corruption and/or
    - Complacency towards the corruption".
  - ❖ Enron had a 300% increase in "whistle-blowing" reports to the Office of the Chairman between 2000 and 2001
    - The directors apparently never considered whether the actions that were the subject of the reports actually made the earnings possible
      - Yet in 2001, 31% of the reports involved criminal activity, 74% of which were reports of fraud

# Perspectives

- **Sherron Watkins' (author of *Power Failure*) background as an investment banker and accountant enabled her to see Enron for what it was**
  - ❖ Summer 2001 anonymous letter to Ken Lay; August 2001 meeting with Ken Lay (30 minutes) triggered by Skilling resignation (saying he could not keep the stock rising in value) and cashing of US\$66 million in options confirming her fears
  - ❖ Later admitted she was naïve to think that Lay would change anything
  - ❖ Ultimately retaliated against (by CFO Fastow), nearly fired and moved to a non-essential job – was looking for another job when scandal broke  
Interview with National Post's Dianne Francis October 2, 2004:
  - ❖ *"This was systemic. Ken Lay made everyone use his sister's travel agency. People were co-opted. I can't tell you how many times I heard the phrase from executives 'it's not perfectly legal, but I think it'll stand up in a court of law'. I saw the warning signs. Why did I ignore them? ... Enron one year handed out US\$750 million to 100 executives even though the company made only a slight increase in profit. ... The pay was great, the trips were great, benefits great and the stock price kept rising. ... In 1996, I saw aggressive accounting that should've made me leave the company, but I went to Enron International where this wasn't going on. ... When the value system is rotten or changes you are best to leave. You can't change it from the middle. In Enron's case, the rot had gone way to the top and down to the second and third level of management."*

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# TONE AT THE TOP

- “The ***control environment*** has a pervasive influence on the way business activities are structured, objectives [are] established and risks [are] assessed. It also influences ***control activities, information and communications systems, and monitoring activities***. This is true not only of their design, but also the way they work day-to-day.”

– COSO Treadway Commission

- The ***integrity, ethical values*** and ***competence*** of the entity's people
- Management's ***philosophy*** and ***operating style***
- The way management assigns ***authority*** and ***responsibility***, and ***organizes*** and ***develops*** its people
- The attention and direction provided by the ***board of directors***
- A 2003 US Conference Board survey on ethics indicated that while many had whistleblowing hotlines a majority of executives believe that fear of retaliation is a big issue in their company

❖ *Only a few had a culture of dissent*

# Benefits of an Effective Program

- **Allowing for anonymous submissions can provide a defence against retaliatory discharge**
- **A formal program allows for effective training and further reduces risk of retaliation**
- **With an effective, protected way for employees to submit concerns, they are less likely to “leak” their story to media or internet**
  - ❖ Toronto City Auditor General runs a highly successful “snitch” hotline to expose bureaucratic waste and criminal behaviour
    - Became permanent November 2002; volume doubled in 2005; hiring practices complaints growing, like Sept. 2005 scandal in municipal licensing office
    - [www.toronto.ca/audit/fraud\\_not.htm](http://www.toronto.ca/audit/fraud_not.htm)
- **A written code of ethics, a meaningful reporting system and protection of whistleblowers from reprisals are key characteristics of an acceptable deterrence and detection program**
  - ❖ Leads to reduced fines and sanctions under the False Claims Act, the US Federal Sentencing Guidelines (Guidant example), US Dept. of Justice Criminal Resource Manual 162 – Federal Prosecution of Corporations, and the SEC’s and OSC’s credit for cooperation policies and are relevant for Bill C-45 criminal code amendments
  - ❖ Also a solution to “constructive knowledge” exposure
  - ❖ Relevant to auditor internal control opinions and management self-assessment of the “control environment”
- **Leads to accountability, which helps defuse resentment and opportunity for corruption (small deviant behaviours often snowball)**
- **Saves reputation and customer relationships**

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## **Benefits of an Effective Program**

- **OSC settlement with CP Ships July 2005 re disclosure and insider trading matters**
  - ❖ Credit for cooperation given due to quick investigation, use of independent committee and transparency to OSC Staff
  - ❖ Company took ownership publicly and said that trades should not have taken place and would be reversed
  - ❖ Company merely got a letter of caution rather than having to defend enforcement proceedings

# Benefits of an Effective Program

- **Amendments to U.S. Federal Sentencing Guidelines – effective November 2004 – pursuant to SOX s.1104**
  - ❖ “Best practices” will be influential for civil litigation as well
  - ❖ Focus on compliance with a broader perspective that examines the corporate culture and the role of ethics and compliance
  - ❖ More rigorous requirements for an effective Compliance and Ethics Program
    - Must exercise due diligence to prevent and detect criminal conduct
    - Must promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law
    - Need effective compliance and ethics training
    - Compliance and ethics officer to be given adequate authority and resources to carry out duties and direct reporting to top executives
    - Must periodically assess risk of criminal conduct (magnitude and likelihood) in light of business and prior history using auditing and monitoring systems – and must periodically assess the effectiveness of preventive and detective controls
  - ❖ Greater responsibility on Boards and executives for oversight and management
    - *Caremark, Disney and Abbott Labs line of cases*
  - ❖ See: <http://www.pli-corpedia.com/link.asp?lid+100091304>

## November 2004 Amendments to U.S. Federal Sentencing Guidelines

- **Original 7 hallmarks of an Effective Compliance and Ethics program**
  - ❖ Prevention and detection procedures; high-level oversight; due care; training and communication; monitoring; consistent enforcement; response and prevention
- **10 Modifications to the Guidelines (Nov. 2004)**
  - ❖ Tone at the top; conduct and internal control; leadership accountability; resources and authority; history of violations; conduct training; evaluate programs; risk assessment; encourage employees; whistleblower system
- **7 Keys to Implementing an Effective Compliance and Training Program**
  - ❖ Understand the necessity of the program and make the commitment; set proper tone at the top; technology is half the battle; be demanding and invest in quality e-learning programs; respect employees' time (balance relevance and learning time); demand that advisors/vendors disclose any possible conflicts of interest; learn from open standards
- **Need to self report in a timely fashion, not tolerate illegal activities and prevent recurrence**

# Revised Federal Sentencing Guidelines – Minimum Requirements

(Ropes Gray September 2004)

- **Adopt standards and internal procedures to prevent and detect criminal conduct – ties to PCAOB Audit Std. 2**
  - ❖ Monitoring and auditing systems – test effectiveness
  - ❖ Whistleblowing infrastructure
  - ❖ Periodically assess risk and modify compliance programs
- **Board must be knowledgeable regarding content and operation of program and reasonably oversee implementation and effectiveness**
  - ❖ Senior management must ensure an effective program
  - ❖ Responsible designated compliance officer reporting directly to Board/committee at least annually (any anytime issues require) and otherwise reporting to senior management
    - Adequate financial resources, appropriate authority
  - ❖ Exclude from supervisory personnel anyone Co. knows/ought to know has engaged in illegal activities or other conduct inconsistent with effective compliance programs
  - ❖ Carrot and stick approach to compensation and promotion
  - ❖ Training; HR reference checks and screening
  - ❖ Address ethics issues and policies at Board and Committee meetings
  - ❖ Information and Communication (COSO)
- **Periodically communicate, through compliance and ethics training and other means of dissemination of information, company standards and procedures throughout organization and to agents**
- **Once illegal conduct detected, must take reasonable steps to respond appropriately and to prevent further similar conduct**
  - ❖ Note PCAOB Audit Standard 2 – failure to correct issues is a potential Material Weakness for internal control reporting and attestation

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# SEC Settlement With Strong Funds May 2004

Release Nos. 34-49741, IA-2239, IC-26448

- Strong Capital Management, Inc. (SCM) entered into an express agreement with hedge fund manager Edward Stern allowing his hedge funds (the Canary hedge funds) to market time certain Strong funds, in order to obtain non-mutual fund business from Stern and his family. The agreement enabled the Canary hedge funds to make approximately 135 round trip trades in four Strong funds, realizing gross profits of \$2.7 million from December 2002 to May 2003. Under SCM's policies and procedures, other shareholders would have been ejected from the Strong funds for engaging in similar trading.
- Thomas A. Hooker, SCM's Compliance Officer, held to have aided and abetted SCM's and Strong's violations of Sections 206(2) of the Advisers Act by failing, after he learned of Strong's frequent trading, to follow up on a directive from the Funds' General Counsel to monitor the trading and ensure it stopped.
- Hooker agreed to pay a \$50,000 civil penalty and was barred from association with any investment adviser or investment company

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# Encouraging Whistleblowing - Amnesty Programmes 2004

- A two-year-old price-fixing probe that began in an obscure corner of the chemical industry has snowballed into a series of international investigations involving industry giants such as Dow Chemical Co., DuPont Co. and Bayer AG.
- The widening web of cases arose from aggressive use by prosecutors of amnesty grants for whistle-blowers, which has rivals competing to be first to report wrongdoing and avoid criminal penalties. U.S. and European investigators currently are looking into alleged conspiracies to fix prices in a half-dozen chemicals used in plastics, rubber and synthetic materials in the U.S., Canada, Europe and Japan. The commodities are used in industries from automobiles to furniture and flooring.
- In pursuing the alleged conspiracies, U.S. and European prosecutors are showing that granting amnesty from criminal charges to the first company to blow the whistle on a conspiracy can be a potent weapon against cartels. Companies granted amnesty can escape huge fines and sometimes avoid jail time for executives.
- Prosecutors have embraced amnesty as an antitrust tool over the last decade, and since 1997 it has resulted in scores of convictions and more than US\$2 billion in fines, according to the U.S. Justice Department. Earlier in 2004, the U.S. Congress passed legislation making amnesty even more attractive. The bill boosts fines and jail time for corporate price-fixing, but it spares companies the threat of triple damages in civil suits if they have won amnesty from the government in related criminal cases. The Justice Department said it also has made the amnesty program more effective by adding so-called amnesty-plus incentives for companies that bring new conspiracies to light -- and penalty-plus, raising fines for those that do not.

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# BACKGROUND

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# Origin of the Word

- **Image of a policeman blowing his whistle at an escaping thief**
  - ❖ Both “blow” and “whistle” have separate slang roots in “spilling of the beans”
  - ❖ Shakespeare’s “The Winter’s Tale”
    - Clown asks: “When are you going to ... whistle off these secrets?”
  - ❖ March 23, 1970 NY Times article: “Blowing the Whistle on ‘The Bosses’”
  - ❖ January 30, 1971: Ralph Nader conference papers such as “The Whistle Blower as Civil Servant” by Senator William Proxmire and “Whistle Blowing and the Law” by Prof. Arthur S. Miller
    - Nader (co-author) follow-up 1972 book titled: “Whistle Blowing”

# Its More Common Than You Think

- U.S. Army Halliburton contract in Iraq: possible conflicts and lack of competitive bidding were issues for officer required to approve 5-year contract
- Coke/Whitely (former finance director) allegations of rigged marketing test, sham transactions and improper accounting (channel stuffing)
- Atlas Cold Storage Income Trust: anonymous letter (April 2003) led to investigation and termination of three senior executives
- KPMG/Hamersley re tax shelter risks and accounting positions
- Livent/Maria Messina and cost allocations
- Office of The Privacy Commissioner/Radwanski budget overruns and accountability for expenses
- Boeing/Lockheed and competitor intelligence/documents
- Moore Wallace Inc. probe triggered by anonymous letter re restructuring charges – CFO suspended amid allegations of construction of audit evidence after the fact
- Guidant 2000 investigation (triggered by whistleblower) led to 2002 charges for failing to notify FDA about medical device malfunctions and mislabelling
- Jiang Yanyong, 72, released July 2004 by Chinese government after 7 weeks of “political re-education” – had exposed government’s cover-up of 2003 SARS crisis, but also written a critical letter about 1989 Tiananmen Square massacre
- Shell overstated reserves

# Its More Common Than You Think

- **Nortel 1999 and 2000 revenue restatement foreshadowed by complaint from John Forster (Texas engineer) laid off in Spring 2001 downsizing**
  - ❖ 1999 letters to executives merely resulted in email thanking him for submission
  - ❖ 2000 internal alert line report and documentation to internal auditor led to telephone call but no further contact
  - ❖ September 2001 meetings with SEC after being laid off
  - ❖ Another employee commenting on 2001 – 2002 restructuring reserves stated that she protested the creation of what she considered unjustifiable reserves but was told they were supported by the Board
  - ❖ When she refused a booking in one case, the company found another obliging manager and she was told to forget about the whole matter
- **UK survey found that almost 50% of public sector frauds uncovered by whistleblowers**
- **Alberta Securities Commission 2005 internal review of management practices and “dysfunctional” and “toxic” work environment**
- **June 2005 revelation that “Deep Throat”, of Watergate fame, was Mark Felt, second in command at the FBI at the time**
  - ❖ Family gave an interview to Vanity Fair May 31, 2005 to raise some money, so Woodward and Bernstein agreed to disclose source as well
    - Had protected source for 33 years

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# Its More Common Than You Think

- **Joseph Wilson (former US diplomat) blew the whistle on Bush administration's claim that Saddam Hussein had tried to buy “yellowcake” uranium for nuclear weapons**
  - ❖ Wife’s ID as a CIA agent on the file leaked
  - ❖ Lead to “Leakgate” scandal and indictment of administration aide Gordon Libby
- **Sibel Edmonds was an FBI translator who was fired when she went to superiors to complain about sloppy and incomplete translations of intelligence information before and after 9/11**

# Spitzer Mutual Fund Investigation 2003 - 2004

- **Spitzer's Mutual Fund crusade triggered by June 2003 call from Noreen Harrington (former Canary Capital Partners hedge fund exec.) re "late trading" by her own fund**
  - ❖ Canary Capital was trading fund shares after 4pm New York time and getting that day's closing price – an illegal practice
- **Led to largest ever probe of U.S.\$7.1 trillion fund industry**
  - ❖ State and federal regulators have since filed charges against numerous fund companies, investors and employees
- **Harrington: "I went to Spitzer because my perception of him was he would fix the problem if I pointed him in the right direction".**
- **See SEC "Spotlight" <http://www.sec.gov/spotlight/mutualfunds.htm>**
- **See N.Y. Attorney General site**
  - ❖ re Janus Capital case:  
<http://www.oag.state.ny.us/investors/investors.html>
  - ❖ Re mutual funds enforcements:  
<http://www.oag.state.ny.us/press/agpress04.html>

# Fannie Mae Accounting Scandal

- **Roger Barnes, former manager of FM financial accounting and deferred assets division, who helped OFHEO in 2003 investigation**
  - ❖ Testimony to House Financial Services Committee:
    - “The atmosphere and culture, particularly within the controller’s division, is one of intimidation, restraint of dissenting opinions and pressure to be part of ‘The Team’ ... The company professes to maintain policies to ensure proper and fair treatment of employees ... The reality is far different”.
  - ❖ Employees who assisted in the effort to “suppress the truth about the accounting and financial irregularities I reported” were promoted by Chair and Vice-Chair
  - ❖ Employees who refused to go along were “ostracized and subjected to retaliation”
  - ❖ Started raising issues in 1999; excluded from meetings starting in 2001; went to Chair and Vice-Chair with memo in 2002
    - Then incurred penalties, with his staff, in performance reviews, internal rewards and denied promotions

# Fannie Mae Accounting Scandal

## – Interim Report from OFHEO October 2004

- “The accounting violations cannot be dismissed as mere differences of interpretation in accounting rules. Fannie Mae understood the rules and simply chose not to follow them.
- In examining Fannie Mae’s amortization modeling, we found that management produced multiple amortization runs, using a wide range of assumptions for future interest rates and prepayment speeds. The goal was to find a way to achieve desired outcomes. ... Moreover, Fannie Mae’s written procedures and documentation for most of its amortization activities have been inadequate.
- Fannie Mae’s development of improper accounting policies and practices can be traced back to a corporate culture and operating conditions characterized by the following:
  - a desire on the part of senior management to portray Fannie Mae as a consistent generator of stable and growing earnings;
  - an ineffective process for developing accounting policies;
  - an operating environment that tolerated weak or non-existent internal controls;
  - key person dependencies and poor segregation of duties;
  - incomplete and ineffective reviews by the Enterprise’s office of auditing;
  - an inordinate concentration of responsibility vested in the chief financial officer;
  - an executive compensation structure that rewarded senior management for meeting goals tied to earnings-per-share, a metric that can be subjected to senior management manipulation.

## **Qwest – SEC Consent Judgment Oct. 2004**

- **SEC complaint alleged that between 1999 and 2002 Qwest fraudulently recognized over U.S.\$3.8 billion in revenue and excluded U.S.\$231 million in expenses**
- **Judgment enjoins further breaches of antifraud, reporting, books and records, internal control, proxy and securities registration provisions of federal securities laws**
- **“Qwest senior management created a corrupt corporate culture in which meeting Wall Street expectations was paramount. Senior management projected unrealistic growth and would not tolerate missing the numbers. As a consequence, accounting rules, policies and controls that interfered with meeting financial targets were ignored. The Commission will continue its investigation in an effort to hold personally accountable those individuals responsible for the fraud”.**
- **See also early testimony in Worldcom (Ebbers) trial regarding pressure to meet the numbers**
  - ❖ MCI (WorldCom) engaged in a 15 month bankruptcy process:
  - ❖ US\$180 bn loss of market value (assets overstated US\$75 bn)
  - ❖ 6 executives facing criminal charges
  - ❖ 600 Deloitte consultants worked full time on a US\$200 million project to restate financials and put controls in place

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# Canadian Federal Government Sponsorship Scandal 2004

- **Sheila Fraser (Auditor General) finds that \$100 million of a \$250 million advertising and sponsorship program intended to raise Federal profile in Quebec after near-loss in 1995 sovereignty referendum went to a small number of Quebec communication firms (and other vendors – such as flag suppliers) without proper accounting**
  - ❖ 1996 and 2000 internal audits ignored (“*Ottawa Ignored Warning*”, Toronto Star, Sept. 29, 2004, p.1) (see also, “*Warning Ignored*”, Globe and Mail, Sept. 23, 2004 p.1 re Michael Calcott and complaint re Groupaction)
    - Whistleblower Allan Cutler had worked under Chuck Guite (director of advertising and public opinion in the Public Works Department 1996 - 1999) prior to sponsorship program
    - Irregularities started in the early 90’s (auditors found records often missing/destroyed) - Cutler began keeping a secret record in 1995
    - Alleges that contracts regularly backdated, commissions paid for services not performed and improper advance payments – turned over his files in 1996 to E&Y investigation
    - Cutler started to refuse to authorize documents with insufficient backup, was then shut out of process and almost lost job before moving to another department
  - ❖ Jon Grant (Pres. Canada Lands Co.) reported to Minister Gagliano and complained repeatedly to Auditor General about 1998 – 2001 interference
    - Gagliano (subsequently ambassador to Denmark) fired February 2004, suing for \$4.5 million for wrongful dismissal

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# Canadian Federal Government Sponsorship Scandal 2004

- **Francois Beaudoin fired from head of FBDB (now BDC) – won wrongful dismissal lawsuit (settled with BDC prior to appeal in Sept. 2004), which lead to firing of President Michel Vennat (also suing for wrongful dismissal)**
  - Had resisted pressure to extend loan to Chrétien associate for hotel
  - Endured harassment, police raids and slander orchestrated by BDC officials
- **Gomery inquiry testimony by retired bureaucrat Mario Parent**
  - ❖ Dysfunctional program
    - Guité ignored Treasury Board competitive bidding rules
    - Allegations of political influence
  - ❖ Constant pressures to blindly sign off on contracts and invoices
    - Only 6 employees administered over \$40 million/year of expenditures
    - Guité frequently absent, so little backup for grant requests
  - ❖ Guité had authority to both award contracts and authorize invoices – functions usually separated in government
    - Guité charged 2004 with six counts of fraud in relation to alleged kickbacks on sponsorship contracts worth \$2 million
- **Gomery report (686 pages) released November 1, 2005**

# Canadian Federal Government Sponsorship Scandal 2004

- ❖ March 2004 Via Rail Chair Jean Pelletier fired for calling Olympic Gold Medallist Myriam Bedard a “pitiful single mother” who was trying to use the scandal to get attention
  - Bedard had seen a pattern of abuses, had complained and been forced out
  - Pelletier had denied Via Rail involved in the scandal: “at worst a certain lack of rigour in the paperwork”
  - Marc LeFrancois (Via Rail’s President who was also terminated) had called her complaints “unbelievable”; “Are these people dreaming?”; “Do they take pills? I don’t know”.
  - Pelletier and LeFrancois are suing for wrongful dismissal and defamation
  - Pelletier ruled improperly dismissed by FCTD decision November 17, 2005 (procedural errors such as failure to give him reasons and opportunity to respond)
    - Government indicates that it will continue to assert substantive reason for firing

# INTRODUCTION TO THE ISSUES

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# INTRODUCTION TO THE ISSUES

## ▪ Internal whistleblower system

- ❖ Opportunity to address problem and take corrective action
  - Earlier corrective action and a system for detecting and acting on breaches of law/ethics is a factor in regulatory liability
    - See for e.g. Bill C-45 (enacted March 2004 re corporate criminal liability) and see U.S. Federal Sentencing Guidelines and OSC/SEC credit for cooperation policies
- ❖ Minimizes or avoids adverse publicity, investigation, prosecution
- ❖ Allows for maintaining a good relationship with the employee
- ❖ Fosters accountability for individual behaviour, which helps defuse resentment and opportunity for corruption and meets COSO goals

## ▪ External whistleblowing

- ❖ Regulators, prosecutors and the news media
- ❖ Bad for all concerned
  - Diminishes ability to exercise effective management
  - Frustrates those pursuing issues internally, as their complaints get bumped down in priority
- ❖ Very easy for employees to disclose as industry critics often run tip/chat websites
- ❖ Regulators now encouraging tips:
  - *“OSC asks consumers for help turning in stock market cheats”*, Toronto Star May 13, 2005 p. C1
  - *“Whistleblower triggered probe into pension plan irregularities”*, Toronto Star July 9, 2005 re Financial Services Commission of Ontario

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**"If I don't get a pay-raise soon, I'm gonna  
blow the lid off this crummy zoo."**

# INTRODUCTION TO THE ISSUES

- **Whistleblowing inevitably raises tensions**

- ❖ Conflicting feelings of loyalty vs. obligations to other employees, stakeholders and the public
- ❖ Precarious position re reporting relationships
- ❖ Subject to harassment, ostracism from peers, retaliation from superiors
- ❖ Often disagreements on the issue

- **Goal is to establish a positive climate that:**

- ❖ Fosters a climate of constructive dialogue and challenging of assumptions (dissent is not disloyalty)
- ❖ Encourages internal reporting without fear of retribution (Atlantic Richfield CEO in 1978 sent a letter to all employees asking them to report product toxicity breaches)
- ❖ Validates expectation that management will not condone and will not have approved or participated in the acts and will conduct an effective, fair investigation within a practical timeline and that something will be done

# Examples of Hostile/Aggressive/Defensive Organizations

## ▪ HealthSouth

- ❖ CEO Scrushy would verbally abuse any dissent (including Board) – 5 former CFOs charged: plot enforced by “threats, intimidation and payoffs”

## ▪ Enron

- ❖ Fastow would verbally abuse any dissent (Lynn Brewer and Sherron Watkins complained without success)

## ▪ Lucent

- ❖ Aversano told: “why don’t you just leave”

## ▪ Global Crossing

- ❖ Company challenged credibility of Olofson (re allegation of improper accounting for capacity swaps)

## ▪ Guidant

- ❖ Workers’ warnings re design flaws or quality issues re implanted medical devices and unproven medical practices putting patients’ lives at risk
- ❖ Anonymous letter written by 7 employees sent to chief compliance officer and FDA indicated stonewalling for months

## ▪ Livent and various Police Force scandals

- ❖ Climate of fear

## ▪ Office of the Privacy Commissioner (Canada)

- ❖ Radwanski promised to end the career of the “rat” who “squealed” on him to Parliament

## ▪ Upper Canada College (see *Time*, Oct. 4, 2004 p.28)

## ▪ Qwest: “senior management ... would not tolerate missing the numbers”

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**"Is the guy in the green jacket the one who  
complained about the baked potatoes?"**

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"I found him working in the stockroom, J. D.  
He's perfect!"

# ***“The Whole Truth and Nothing But”***

*Business 2.0, October 2004, p.78*

- **Harrah’s CEO (ex-Harvard prof.) praised for first nation-wide loyalty program in gaming industry, precision target marketing and customer service culture**
  - ❖ Culture of decision-making driven by facts and evidence
  - ❖ Telling the truth and admitting mistakes demanded
- **Intel culture of “constructive confrontation”**
  - ❖ Encourage disagreement/alternative views to ensure better decisions
- **Most CEO’s don’t know what is going on and can’t therefore make effective decisions**
  - ❖ Subordinates naturally only want to communicate good news
- **Many executives are complicit in the problem**
  - ❖ Problems are a distraction and force senior execs to get involve to help solve
  - ❖ Potential communication issue for Board and market
- **Truth Serum:**
  - ❖ Drive fear out of the organization
  - ❖ Everyone makes mistakes, admit them, learn and move on
  - ❖ Corporate climate where it is OK to ask for help
    - Trying to “bluff” or “manage” out of problems is worse
  - ❖ Culture of “no surprises”
    - Enables strategy planning and scenario analysis and stress testing of the system against possible risks

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# People Who Know Often Stay Silent

- **HealthSouth; Global Crossing; WorldCom; Enron; Tyco; Ahold; Guidant; Livent; Office of the Privacy Commissioner; Adelphia; Putnam Funds**
- **Hollinger story well known, but Tweedy Brown and Jarislowsky unable to interest regulators**
  - ❖ Press subject to libel chill and threat of industry blackball
- **Personal effect (such as harassment or if ordered to participate in wrongdoing) was more likely to lead to WB than if mere ramifications to company or public interest**
- **August 2003 survey showed 27% of Nova Scotia civil servants said they had witnessed mistakes, corruption, ethical misconduct or unsafe conditions at work that should be exposed, but were too afraid to report**
- **Auditor General of Canada report re 2002 survey:**
  - ❖ 13% of responding public servants noted awareness of wrongdoing but 65% of those had not reported

# People Who Know Often Stay Silent

- **Polling firm Leadership Unlimited Inc. surveyed 48 of 108 employees in the Office of the Privacy Commissioner for the Cdn. government between July 30 and Aug. 19, 2003 (6 weeks after Radwanski resignation):**
  - ❖ 63% were aware of wrongdoing since Nov. 2001 that they hadn't reported
    - Fear of reprisal (92%); lack of faith in managers' ability to protect staff (69%); lack of faith in managers' intent to protect staff (58%)
  - ❖ 63% didn't think that policies like subsequently proposed Bill C-25 (March 2004, since reintroduced as C-11) would protect them, due to lack of trust in managers
    - Only 6% felt the policy would work
    - 38% felt that confidentiality would be breached
    - 38% didn't think that protection from reprisal was possible
- **Troy Normand, a WorldCom finance employee, in testimony to the US House Committee on Energy and Commerce, indicated that in 2000 he had expressed concerns about accounting entries that were “wrong and [went] beyond aggressive accounting” to Scott Sullivan (CFO) and in 2001 to David Myers (Controller), but had not approached internal auditors or external auditors because he was “concerned for his job and [had] a family to support”**
- **Many US studies support these statistics as well (as well as UN Secretariat 2004 study)**

# People Who Know Often Stay Silent

- **April 2004 article about a former Echo Bay Mines official (laid off after 2002 merger with Kinross Gold) who alleges that when he worked as project manager for a Philippines mine in 1996-1997, Echo Bay paid US\$2 million to terrorist and insurgent groups (some al-Qaeda-linked) in exchange for protection**
  - ❖ Senior managers told him: “this is how you do business in the Philippines”
  - ❖ Provided documents to US Justice department investigation
- **Many revelations come out in “exit interviews” or in wrongful termination suits or through tips from angry spouses**
  - ❖ E.g. *“Family Feuds Don’t Get Nastier Than This”*, BusinessWeek, February 10, 2003, p.62
  - ❖ *“Inside MassMutual Scandal, An Angry Wife Sparked Probes”*, The Wall Street Journal, Aug. 19, 2005, p.A1
- **Attitudes possibly changing: Time Magazine December 30, 2002, quoting a Time/CNN poll:**
  - ❖ 59% view whistleblowers as heroes
  - ❖ 73% would themselves become whistleblowers if they observed serious criminal wrongdoing at work

# Perpetual Cultural Problem - NASA

- **Reports after each of:**

- ❖ the Apollo 1 fire
- ❖ the 1986 Challenger solid rocket booster explosion
- ❖ the Feb. 2003 Columbia failure on re-entry

**found a dysfunctional atmosphere which led to complacency, overconfidence, safety sacrificed to meet budgets and deadlines and internal warnings to be stifled/overlooked**

- **Columbia Accident Investigation Board report found foam shielding shedded on virtually all flights – NASA failed to ask the right questions and “broken safety culture” as much to blame as technical issues**

- **Applying lessons learned critical to organizational recovery**

- ❖ Overreaction? Then NASA Chief concludes that Shuttle design too risky for planned 2005-2006 upgrade/repair mission for Hubble Space Telescope (shuttle to be limited to International Space Station work) – 2 NASA engineers dissenting reports (feared they would lose their jobs if their names were made public) leaked to Reuters by a NASA astronomer
- ❖ Protests have lead to a re-examination by the Space Studies Branch of the National Academy of Sciences of NASA Chief Sean O’Keefe’s decision – possible role for MD Robotics of Brampton ultimately denied on basis that repair mission so complicated that humans required
- ❖ 2004 survey found lagging practices and resulted (April 2004) in three-year program to change culture – starting with 5 month series of management meetings and coaching

**Brian Ludmer, Nov. 2005**

# NASA – THE SOLUTION

- **“NASA Notes Some Progress In Making Shuttles Safer”**  
*NY Times August 27, 2004 p.A14*
  - ❖ After one year of work, 5 of 15 mandatory recommendations from the Columbia Accident Investigation Board report (Aug. 26, 2003) have been satisfied and the remaining 10 were expected to be completed by December 2004
    - Shuttle *Discovery* to launch March-April 2005 to International Space Station
    - NASA set bar higher than committee – “as engineers looked into the shuttle system they found many other things that needed fixing, validating the Investigation Board’s concerns”
  - ❖ NASA officials stated at Aug. 26, 2004 news conference that the agency had come a long way in reforming itself, but realized that it had more work to do
  - ❖ Dr. Thomas Krause, chairman of Behavioural Science Technology Inc., was hired to reform NASA’s culture and internal communications
    - Company agents have been analyzing and coaching NASA team leaders at headquarters and regional centres
    - “We are seeing leaders beginning to to things differently ... In a company, changing culture is essentially about leadership”.
    - Meetings appeared to be more open and leaders were doing better at seeking more opinions, including dissenting ones
    - Lower level employees were indicating that they were becoming more comfortable communicating with their superiors
- **Yet on return to flight, foam shedded again.**  
**See “For NASA, Misjudgements Led to Latest Shuttle Woes”,**  
***The New York Times, July 31, 2005, p.1***

Brian Ludmer, Nov. 2005

# Perpetual Cultural Problem – Healthcare Fraud

See, “*Corporate Accountability and Compliance in Health Care, February 27, 2004, Kimberly Baker and Arissa Peterson, Williams, Kastner & Gibbs, PLLC*”

## ▪ Tenet

- ❖ Second instance within 10 years
- ❖ CEO at time of second scandal had taken over from founder after first scandal
- ❖ General Counsel had significant stock option gains in period prior to revelations
- ❖ Scheme concocted to boost stock price in face of institutional investor proxy contest

## ▪ Columbia/HCA

- ❖ 1997 investigation was longest and costliest health care fraud investigation in history – formally closed August 2004
- ❖ Led to more than 12 criminal and civil charges and fines exceeding US\$1.7 billion

## ▪ Others: Quorum Health Group, Vencor, National Healthcare Corp., drug companies and hospitals

- ❖ See, *An Opportune Time for Fraud Disclosures?*, New York Law Journal, January 29, 2002

## ▪ Recent Justice Department recoveries from healthcare industry

- ❖ HCA U.S.\$641 million; Abbott Laboratories U.S.\$382 million; AstraZeneca U.S.\$355 million; Warner-Lampert U.S.\$430 million; Bayer U.S.\$257 million; GlaxoSmithKline Beecham U.S.\$47 million; Tenet U.S.\$51 million; Endovascular Technologies U.S.\$88 million; TAP Pharmaceutical Products U.S.\$885 million; HealthSouth U.S.\$325 million; Pfizer U.S.\$430 million; Scheering-Plough U.S.\$345 million
- ❖ See “*Rx for Fraud*”, Forbes, June 20, 2005, p.124

Brian Ludmer, Nov. 2005

# Moral Justification Requirements

1. **Act/omission must be seriously and demonstrably harmful to the public interest and not merely a disagreement over policy**
2. **Sufficient evidence is required to go outside the chain of command or other internal channels**
3. **Should have fully exhausted internal channels' ability to correct perceived harm**
4. **Should have good reason to believe that the disclosure will bring appropriate change and result in net benefit**
5. **Motivation must serve the general interest and not private interests or agendas – consider why much comes out in exit interviews**

# Whistleblower Bill of Rights

(drafted by Tom Devine, legal director, Government Accountability Project)

- The right to communicate within the profession, on the job and with colleagues
- The right to be part of an institution whose leadership makes integrity the cornerstone of professional expectations
- The right to due process for those who witness wrongdoing and allege harassment
- The right to information, on the record, to permit responsible dissent while holding accountable those who make false reports
- The right to make a difference by submitting misconduct concerns to an independent forum that is free from conflict of interest
- The right to an expedited, timely decision when exercising legal rights
- The right to interim relief while legal proceedings run their course
- The right to sanctions against those who retaliate
- The right to be “made whole” through relief for tangible and intangible wounds of retaliation
- The right to vindication, including public recognition

Brian Ludmer, Nov. 2005

# ISSUES FOR THE COMPLAINANT

# ROOTED IN US CULTURE

- **Individualism, Populism and the Nader/consumer movement (1960s and 1970s)**

- ❖ Lionized by political and intellectual activists amidst anti-establishment mood and depicted as a noble force of dissent and improved public policy against the daunting might of government bureaucracies and corporations

- **Movies:**

- ❖ *Serpico* (NYC police corruption) (*Al Pacino 1973*)
- ❖ *All The President's Men* (Watergate) (*Dustin Hoffman and Robert Redford 1976*)
- ❖ *The Insider* (1999) Jeffrey Wigand (tobacco researcher who revealed that Brown & Williamson Tobacco Corp. knew product addictive) played by *Russell Crowe*
  - See interview of Wigand in Time Magazine Feb. 14, 2005, p. 4
- ❖ *Silkwood* (*Meryl Streep 1983*) and *The China Syndrome* (*Jack Lemon 1979*) re nuclear power
- ❖ *A Civil Action* (*John Travolta 1999*) and *Erin Brockovich* (*Julia Roberts 2000*) (environmental contamination)
- ❖ In the movies, heroes were vindicated, however .....

# THE REALITY: CAREER SUICIDE – WITH NO APPLAUSE

- **Aug. 2002 survey by The National Whistleblower Centre showed that over half are fired**
  - Rita Reynolds (May 2003) re Union Station Toronto tenders
  - Paula Leggieri re MFP Financial City of Toronto computer lease
  - Dwight Turner (assistant town clerk of Oakville) put on paid leave after reporting Nov 2003 election irregularities to town city councillors
  - Roy Olofson of Global Crossing
  - Jared brown of Wal-mart re 2005 tip about Vice-Chairman's expense account abuses
- **1987 Survey by Integrity International**
  - 82% experienced harassment; 60% were fired; 17% lost homes; 10% attempted suicide
- **Other retaliation or adverse consequences:**
  - Sued for breach of confidentiality/fiduciary duty (Jeff Wigand)
  - Demotions or “poor performance” reviews (methodically accumulating mistakes) and loss of expected promotions
  - Transfers to non-core divisions/assignments or positions beyond their capacity
  - Elimination of position through restructuring
  - Ostracism by superiors and colleagues (“branded” as disloyal or troublesome)
  - Industry blackball: Sherron Watkins (Enron); Ted Beatty (Dynegy)
  - Abuse, insults, physical threats, psychological attacks, false allegations (Adelphia CFO re option grants to director investigating Rigas allegations; Wigand 500 page dossier compiled by employer)
  - Aggressive litigation (Hilson/Philip Services libel action, GE suit to reclaim FCA award)
  - Death threats alleged by City of Toronto business licensing inspector who alleged corruption
    - See “Toronto Inspector Threatened with Death”, Toronto Star, Nov. 4, 2005, p.1

**Brian Ludmer, Nov. 2005**

## **THE REALITY: CAREER SUICIDE – WITH NO APPLAUSE**

- **“It is profoundly moving and amazing to observe the agony, despair, economic hardship and loneliness that many of these people have had to endure and then hear them say, even in the darkest moments, that they would do it all again”. – Louis Clark, President, the Government Accountability Project**
- **Rita Reynolds (formerly Toronto’s freedom of information officer) filed a \$5 million lawsuit against City of Toronto and senior officials in July 2003 (still pending July 2005)**
  - ❖ Divulged that key documents used to select successful bidder to renovate Union Station had been destroyed
  - ❖ Refused to go along with attempts by bureaucrats to mislead council
  - ❖ Berated for not protecting interests of her superiors and for not being a “team player”
  - ❖ Alleges hostile work environment and campaign to discredit her and build a case to fire her
- **Allan Cutler (sponsorship scandal whistleblower) was shunted aside and kept in low-level positions before being terminated – public service union grieved dismissal and won reinstatement, but not effectively reintegrated**

## The Reality (2) – Loss of Confidentiality

- **While a concern for the discloser of wrongdoing, the alleged wrongdoer and witnesses, it is often hard to maintain anonymity, or even confidentiality**
  - ❖ Prosecution of company and wrongdoer will require, or effectively cause (by nature of information and documents revealed) disclosure of identity
  - ❖ Nature of allegations might tip off other employees as to identity
  - ❖ Often required by access to information legislation or rights of defence of wrongdoer
  - ❖ U.S. PSLRA (1995) decisions re pleading standards and disclosure
  - ❖ Privacy leaks:
    - Linda Tripp (the Clinton – Monica Lewinsky story)
    - CIA agent Valerie Plame (spouse of Bush critic and former ambassador Joseph Wilson)
    - David Kelly, UK weapons expert whose suicide re disclosure of his role in Iraq war justification was politically explosive
      - Lord Hutton report (Jan. 2004) exposed poor editing, deteriorating journalistic values and sloppy management practices at the BBC
    - Saskatoon emergency room doctor letter to Minister of Health (mid 90's)
  - ❖ Anonymous allegations easily dismissed

# The Reality (2) – Loss of Confidentiality

## ▪ Access to Information Act (Canada)

- ❖ Enables people (\$5 fee) to request government-held records ranging from expense reports and audits to correspondence and policy positions
  - Exceptions for confidential commercial data, national security, etc.
- ❖ 2002 Federal task force recommended expanding coverage to most crown corporations
- ❖ CBC submission to Dept. of Justice expresses concerns about losing control of information related to confidential files of investigative reporters
  - Concerned that sources will dry up

## The Reality (2) – Loss of Confidentiality

- **Cadillac Fairview suit against Standard Parking re theft of parking receipts**
  - ❖ Defence won Feb. 2004 motion requiring release of names of two employees who had contacted plaintiff
- ***R. v. National Post* (69 O.R. 3<sup>rd</sup> 427) Jan. 21, 2004 Ont. Sup. Ct. J.**
  - ❖ Held that a police search warrant that would have forced a journalist to reveal a confidential source for a politically-charged story (Chrétien conflict of interest allegations) should never have been granted
    - *Charter of Rights* protects freedom of the press and common law right of privilege/confidentiality discussed in light of importance of “informants” to press
    - Being appealed by Ontario Ministry of the Attorney General
- **“Confidential Informant Privilege” being argued as reason to justify order prohibiting disclosure of journalist who tipped RCMP to potential political corruption in Airbus procurement scandal**
  - ❖ See: “*Journalist feared having identity exposed, court told*”, Toronto Star, June 2, 2004, A.19
- **USSC 1991 decision in *Cohen v. Cowles Media Co.* - promises of confidentiality by a reporter are enforceable contracts**

# The Reality (2) – Loss of Confidentiality

## ▪ Leakgate in the U.S.

- ❖ Matthew Cooper of Time magazine and Judith Miller of The NY Times convicted of contempt for refusing to indicate source to grand jury
  - Cooper avoided jail as his source agreed to let him disclose
  - Miller served 85 days in jail before source allowed her to testify
  - Bob Woodward never called to testify to grand jury but was also tipped
- ❖ Huge debate ongoing about public policy on confidential media sources, media ethics and quality control, use of freelancers, etc.

## ▪ Dec. 2004 Hamilton Spectator reporter Kenneth Peters found in contempt for by Ont. Sup. Ct. in libel litigation and ordered to pay Cdn.\$31,600 to other parties

- ❖ No consideration given to *National Post* case
- ❖ Decisions in both cases being appealed

## ▪ *R. v. Gnanachandran* 2005 CanLII 24921 (ON. S.C.) protected confidential police informant as determined that accused could otherwise answer case against her

# Issues for the Complainant

## 1. Career on the line – discuss with family, friends, peers and support network

- Make sure that it is a major matter that can't be handled another way (through the system or anonymously) and examine your motives
- Are the allegations reasonable and can they be proven?
- Will it make a difference?
- The family of reservist military police Staff Sgt. Joseph Darby, who sounded the alarm about abuse of Iraqi detainees in 2004 at Abu Ghraib prison, was living in protective custody due to threats

## 2. Examine alternative reporting paths for risks/opportunities and anonymity

- Many issues/companies have online tip sites, such as the FBI, the National White Collar Crime Center, the Software Business Alliance and the National Centre for Missing and Exploited Children
- Consider leaking the information to a trusted third party who will then pass it on to the appropriate party

## 3. Keep a log/diary, capture all insights and copies of supporting documents – can you back up your case?

- Use careful, balanced language, as it is producible
- Don't embellish

# Issues for the Complainant

## 4. Identify third party support groups

- There are law firms and forums that specialize
  - Significant differences in legislation (sanctions, remedies, nature of covered acts, who to report to, nature of required evidence)
- Integrity International; Government Accountability Project (legal representation and policy reform - [www.whistleblower.org](http://www.whistleblower.org)); Project on Government Procurement; National Whistleblower Center
- Sierra Legal Defence Fund (Canada) and Democracy Watch (Ottawa)
- Federal Accountability Initiative for Reform (Ottawa)
  - [Fair.Canada@sympatico.ca](mailto:Fair.Canada@sympatico.ca) (Joanna Gualtieri – federal whistleblower)
- Public Employees for Environmental Responsibility
- Public Concern at Work (UK Charity)
- Online discussion groups
- Drug Safety Canada awards (profiled Toronto Star May 9, 2005 p.A3)

## 5. Be on best behaviour and continue to perform at work

- Pursue the issue on your own time and at your own expense

## 6. Focus on disclosure of facts, not the personalities

- Don't wear cynicism on sleeve

# Issues for the Complainant

## 7. Blow the whistle before you are personally implicated

- Joseph Bourgart, CFO of Vital Signs Inc., had signed one SOX certificate before he resigned because he had not been able to persuade the CEO to correct what he considered to be inflated valuations for inventory and an investment in China, as well as understated values for expenses (such as supplier rebates and taxes)
- Betty Vinson (five months prison, five months house arrest), Buford Yates (one year and one day in prison) and Troy Normand (three years probation), mid-level WorldCom accountants, got caught up in the accounting scandal, despite their reservations, in response to a direction from Controller David Myers (One year and one day in prison) to book fictitious entries
  - See, *“How Following Orders Can Harm Your Career”*, October 3, 2003 (online at <http://www.cfo.com/Article?article=10851>)
  - See, *“Prosecutors Tough New Tactics Turn Firms Against Employees”*, (WSJ online, June 4, 2004).

# Issues for the Complainant

## 7. Blow the whistle before you are personally implicated (cont'd)

- Nina Aversano (former President of North American “service provider” sales at Lucent) charged by SEC (May 2004 Litigation Release LR-18715) with aiding and abetting revenue overstatement
  - Had filed suit against Lucent (Fall 2000 – settled January 2003) alleging chairman Rich McGinn (subsequently ousted) fired her after a meeting in October 2000 at which Aversano told McGinn his sales targets were unrealistic
  - Had earlier succumbed to pressure exerted by CEO to meet his guidance to the “street” re earnings growth
    - Previous and subsequent CEO Henry Schacht said that, under McGinn, Lucent was “driven by Wall Street expectations that were beyond the capacity of the company to meet”
    - See “*The Whistleblower and the CEO*”, Fortune Magazine, June 23, 2003
- HealthSouth CFO and whistleblower Weston Smith, who tipped the FBI in early 2003 was sentenced to 27 months in prison and one year of probation, plus U.S.1.5 million in asset forfeiture

# SO WHAT MOTIVATES A WHISTLEBLOWER?

- **“professionals” and “honesty/integrity idealists”**
  - ❖ Workaholics who take their jobs very seriously
  - ❖ Cannot accept incompetence or unethical or unauthorized conduct in others
  - ❖ Idealistic/naïve belief that honesty, integrity and performance is always expected
  - ❖ Believe in the company – best and the brightest (and catalysts for change) rather than old-style disgruntled employees
  - ❖ E.g. Allan Cutler (Cdn. Federal government sponsorship scandal whistleblower) described by daughter: “He does have a strong work ethic and a high moral integrity. He thought things were going wrong and he spoke up for it, because that’s just the type of guy he is.”
- **“self-protectors”**
  - ❖ Cut the first deal with the regulators
  - ❖ A common SEC ploy in accounting or fraud cases
- **“corporate outliers”**
  - ❖ Weren’t part of the mainstream that benefited from the activity; or
  - ❖ Not brought into the loop but stumbled on scheme
- **“religious/moral” beliefs**

# SO WHAT MOTIVATES A WHISTLEBLOWER?

- **Remaining silent creates its own problems**
  - ❖ Anxiety affects mental and physical health
  - ❖ Being ignored undervalues them as professionals
  - ❖ Worry about others being hurt by wrongdoing
  - ❖ Questions regarding legal obligation to speak out vs. legal duty of confidentiality
    - Child protection laws; professional rules; securities laws; “aiding and abetting laws” (Betty Vinson of WorldCom)
- **1987 Integrity International Study**
  - ❖ “A whistleblower is a cross between a bloodhound and a bulldog – he will track down the wrongdoing and stand his ground. His conscience is very strong, unwavering. He is the first one to feel guilty when something happens”.
- **Today’s whistleblower is still idealistic in some ways, but has the protection of certain legislation – so may be considered less heroic (and in some ways more stable, credible, substantial and senior)**
  - ❖ Environment of ethics hotlines; ombudsmen; ethics training and committees

# UNITED STATES LAW

# History and Breadth of US Whistleblower Legislation

- Statutes providing for actions by a common informer, who himself had no interest in the controversy other than that given by statute, have been in existence in England for hundreds of years and in the U.S. since its founding
- History, constitutionality and jurisdictional and threshold issues discussed in U.S. government memorandum dated June 9, 1999 submitted in *U.S.A. and James F. Alderson v. Quorum Health Group*,
  - ❖ U.S. District Court for Middle District of Florida, Case No. 99-413-CIV-T-23B

# U.S. Pre-SOX Law re Financial Whistleblowers

- **Employee alleging financial fraud had no legal protection except for a handful of state laws and then only if the matter affected the general public**
  - ❖ Sherron Watkins would not have been protected
  - ❖ See, “*The State of State Whistleblower Protection*”, 38 AM. BUS. L.J. 99 (2000)
  - ❖ See, “*The Year of the Whistleblower: A primer on the Anti-Retaliation Provisions of Sarbanes-Oxley*”, Fred W. Alvarez and Michael J. Nader (February 2004) online at [www.ali-aba.org](http://www.ali-aba.org)
- **State of Connecticut took out ads in the Ottawa Citizen January 2004 telling current and former employees of JDS Uniphase that they can ignore confidentiality agreements that they signed with employer (apparently on basis of US jurisprudence – JDS now a US company) to provide investigators with information about improper activities**
  - ❖ Conn. State Pension Fund had lost \$65 million in JDS meltdown and is lead plaintiff in class action

## History and Breadth of US Whistleblower Legislation

- **S-OX is only the latest of a long list of WB Statutes going back to The False Claims Act of 1863, which is still on the books**
  - ❖ A federal civil statute that imposes liability on “any person who knowingly presents, or causes to be presented, to an officer or employee of the US government a false or fraudulent claim for payment or approval”
  - ❖ Origin: civil war manufacturers who substituted sawdust for gunpowder or recycled mixed metals for iron
  - ❖ FCA originally shared 50% of the recovery with tipster – removed in 1943 and fell out of use
    - Government could also take over case and displace complainant
  - ❖ Renewed emphasis with Ralph Nader’s 1971 editorial in NY Times: “*A Code for Professional Integrity*”
  - ❖ FCA used for 1983 revelations of profligate defence spending (\$600 hammer and \$1,000 toilet)

# The False Claims Act

- FCA amended 1986 to allow up to 30% sharing re federal government contractors' fraud ("*qui tam*"); burden of proof reduced to "deliberate ignorance" or "reckless disregard" of regulations
  - ❖ Complainant cannot be displaced but government can join suit
  - ❖ FCA also contains retaliation prohibition where employer aware of protected conduct; potential remedies include reinstatement with double back pay plus interest, special damages and attorneys' fees
  - ❖ Sharing of recovery was debated 1986 – 1996; now accepted given scandals
  - ❖ Procedure: whistleblower files suit and kept under seal for 60 days – only Justice Dept. and court informed. Justice Dept. decides whether to intervene and litigate the suit for itself.
    - If yes: whistleblower ("*qui tam* relator") can still get 15-25% of judgment or settlement, depending on extent of assistance
    - If no: whistleblower can go it alone and try to get 25-30%
    - If court determines source of information was actually media/government, then whistleblower gets 0-10% (depending on whether the whistleblower was an "original source")
    - Whistleblower can also get reasonable expenses, costs and attorney's fees
    - Much litigation re public vs. non-public information and whether "first-to-file"
    - Civil penalties are \$5,000 to \$11,000 for each violation – double damages if defendant is cooperative and triple damages if defendant is not; plus costs of litigation

# The False Claims Act and State WB Statutes

- From 1995 to 2003, FCA cases have recovered more than U.S.\$8 billion for the taxpayers, (over U.S.\$12 billion since 1986); U.S.\$6 billion from cases initiated by whistleblowers
- In 2003 alone, U.S. federal gov't won U.S.\$2 billion (2002 – U.S.\$1.1 billion; 2001 – U.S.\$1.6 billion) from FCA cases and paid over U.S.\$319 million (2002 – U.S.\$160 million; 2001 – US\$120 million) to whistleblower plaintiffs
- Columbia/HCA case (U.S.\$745 million recovery for false cost reporting and other violations) led to U.S.\$152 million payment to group
- Active plaintiffs bar working on contingency fees
  - ❖ E.g. private lawsuits and FCA lawsuits pending against PricewaterhouseCoopers (2004) for travel expense reimbursement accounting
- April 2004 settlement of FCA claims against CMC Electronics re used and surplus components sold for Patriot missile systems
  - ❖ Montreal-based employee received U.S.\$1.5 million of U.S.\$9.6 million payment to U.S. government
- The former Putnam Investments employee who tipped regulators about improper mutual fund trading (leading to a US\$50 million fine) is suing for his share under Massachusetts' whistleblower statute after State denied his claim because he didn't technically comply because he approached regulators instead of the State AG and had not commenced his own claim

# The False Claims Act and State WB Statutes

- **Chicago resident suing internet retailers for failing to collect state retail sales tax (collectible if physical presence in the state)**
  - ❖ Where state of Illinois joins the suits and prevails her is entitled to 25% of the recovery
  - ❖ Has expanded his franchise to Tennessee, Nevada and Virginia, which have similar statutes
- **October 2005 agreement by Serano Laboratories Inc. to pay US\$704 million fine to resolve criminal charges and civil allegations related to marketing of its AIDS drug Serostim**
  - ❖ Kickbacks to doctors and misleading marketing led to 85% of prescriptions written being wasted
  - ❖ Five employees who filed FCA lawsuit will share expected US\$75 million payout with The Aids Healthcare Foundation, which had launched its own suit (the two groups had squabbled and litigated over the sharing)
  - ❖ Fine is the largest ever in a Medicaid fraud case and the third-largest health care fraud recovery
- **See “*The Dark Side of Whistleblowing*”, Forbes, March 14, 2005, p.90**
  - ❖ Employees sit on claims to allowed recovery to grow; government bullies companies into settlements; employees of target company often not convicted after company had paid up
  - ❖ One whistleblower received US\$126 million for two FCA claims against TAP and the former Zeneca Inc.

# Northrop Grumman Corp. FCA Suit

- **Originally filed in 1989 by two former employees acting as whistleblowers, case taken over by DOJ in 2001**
  - ❖ **Certain files to be unsealed and trial was scheduled to start in 2004**
- **Suit alleges cost accounting improprieties and records alteration re military programs**
  - ❖ **Procedures for keeping track of production materials, program costs, etc. were unreliable**
    - **Company certified billings to Pentagon monthly**
    - **Company misled Pentagon auditors about the extent of the problems while they scrambled to fix them**
- **Without admitting wrongdoing, company in 2003 paid U.S.\$191 million to settle three other FCA suits alleging Pentagon overcharges during the 1990's**

## History and Breadth of US Whistleblower Legislation

- **Civil Service Reform Act of 1978** marked the emergence of the whistleblower protection movement for certain federal government employees
  - ❖ Office of Special Counsel
  - ❖ Merit System Protection Board
- **Whistleblower Protection Act of 1989**
  - ❖ Lowered standard of proof required
    - Employee need only show that protected disclosure was “a factor” (rather than predominant or motivating factor) in the subsequent negative personnel action or inaction
    - Once shown, burden of proof shifts to employer
  - ❖ Specific private industries added to scope
  - ❖ Has been amended many times, in conjunction with state legislation, but remains a patchwork of coverage re type of industry, type of conduct and particular state.

# ***“Congress Moves to Protect Federal Whistleblowers”***

New York Times October 3, 2004 p.21

- **“The Whistleblower Protection Enhancement Act (H.R. 3281)”, a bipartisan bill (108<sup>th</sup> Congress) which seeks to restore protections for federal employees who report illegalities, gross mismanagement and waste, and dangers to the public health and safety, unanimously passed the House Government Reform Committee Sept. 29, 2004**
- **This legislation is the House companion to a bill already introduced in the United States Senate (S. 2628) by Senators Daniel Akaka (D-HI) and Charles Grassley (R-IA), which was approved unanimously by the Senate Committee on Governmental Affairs on July 21, 2004.**

**Brian Ludmer, Nov. 2005**

# **“Congress Moves to Protect Federal Whistleblowers”**

New York Times October 3, 2004 p.21

- The Senate Bill would amend chapter 23 of title 5, United States Code (merit systems principles for US civil service). The House bill would also amend the Whistleblower Protection Act (WPA).
- The bills now have to be reconciled. Both have the goal of responding to a series of decisions by the Court of Appeals for the Federal Court, which have weakened the WPA. The Federal Circuit Court has sole authority to review cases under the WPA and has stated in various cases that:

An employee is not protected by the WPA if he or she directs criticism to the wrong-doer (or up the chain of command) instead of to a higher authority.

An employee is not protected by the WPA if the information was disclosed in the course of his or her duties or relates to policies

An employee is not protected by the WPA if the information disclosed is already known.

A federal agency is often assumed to have acted properly unless an employee offers irrefutable evidence to the contrary.

The legislation would also clarify the right of federal employees to provide evidence of breach of law, rule or regulation, “gross mismanagement” or false and material statements to Congress free of threats or reprisals, even if relating to “classified” information (national defence or foreign affairs), provided the disclosure is made to authorized members or employees of Congress.

The legislation would also prohibit the implementation or enforcement of non-disclosure policies or agreements conflicting with the whistleblower protections and requiring statements of statutory protections in any such agreement

Brian Ludmer, Nov. 2005

# **“Congress Moves to Protect Federal Whistleblowers”**

New York Times October 3, 2004 p.21

## ▪ **Remaining Issues: Policy Decisions**

- ❖ Retaliatory acts prohibited in respect of “disclosures” of information the employee reasonably believes is evidence of “gross mismanagement, a gross waste of funds, an abuse of authority or a substantial and specific danger to public health or safety”
- ❖ “covered position” excludes positions: ... “ excepted from the competitive service because of its confidential, policy-determining, policy-making, or policy-advocating character”
- ❖ Recent legislative debates recounted the following cases:
  - Border patrol agents disciplined for disclosing weaknesses along Canadian border
  - Chief of U.S. Park Police fired for stating that budget insufficient to protect parks and monuments in Washington area
  - Chief Medicare actuary threatened with firing if he provided data to Congress showing the cost of a new Medicare law, which exceeded White House estimates
  - Airport baggage screeners penalized for raising concerns about airport security (Merit Systems Protection Board held that this was an exempted industry)

## ▪ **Bill s.494 introduced in U.S. Senate March 2, 2005 (109<sup>th</sup> Congress)**

**Brian Ludmer, Nov. 2005**

# History and Breadth of US Whistleblower Legislation

- **March 2004 stats from Government Accountability Project**
  - ❖ 29 federal statutes with varying schemes of protections for private and public sector employees
    - Homeland Security Act 2002 re terrorists' acts and future plans
    - Pipeline Improvement Act (health and safety)
    - US federal criminal prohibition against violent retaliation (rather than economic retaliation) against a witness or informant
- **U.S. state legislation (Nov. 2003):**
  - ❖ 12 states give overall blanket protection to anyone who discloses a violation of state or federal laws or regulations and 3 of these 12 also protect reporting of breaches of Codes of Conduct/Ethics
  - ❖ 42 states have a cause of action for retaliatory discharge, though such protection at times has been limited
  - ❖ Some states even reward disclosure (like FCA);
    - California 10% award of resulting government or corporate savings
  - ❖ New Jersey's *Conscientious Employee Protection Act* offered some of the strongest protection in the US for workers reporting to public officials – can sue for reinstatement, back pay, punitive damages and legal fees
  - ❖ Texas – home of Enron and situs of a WorldCom whistleblower suit in 2002 – had no protection; only protection for refusing to conduct illegal acts

# Example of State Law and Importance of Specific Terms of Whistleblower Statues

- **Since early 1980's NY state had a law protecting “whistleblowers” generally**
  - ❖ NY Labour Law s.740 prohibits retaliatory action by employers and offers protection to employees who disclose practices that violate the law or who object to participating in illegal activities
    - Requires an actual violation of law, rule or regulation rather than merely reasonable belief
    - Cause of action for retaliation only re danger to public health and safety
  - ❖ 2002 added NY Labour Law s.741
    - Specifically prohibits retaliation against health care workers who report violations to government agencies
    - Creates civil cause of action
    - Protects reports of potential danger to individual patients
    - Mere good faith and reasonable belief required, rather than actual violation

# CANADIAN LAW

# Protection for Canadian Whistleblowers at Common Law

- **Employees owe a duty of loyalty, good faith and, in appropriate circumstances, confidentiality**
  - ❖ Where employee breaches duties and reveals a confidence or some information (believing it in the public interest):
    - Discipline or dismissal resulting in court action or collective agreement grievance procedure
  - ❖ Where the wrongdoing is serious and the public's interest in disclosure is clear, the courts have permitted a very limited "public interest" defence
    - Must use internal remedies first, to be sure of facts
      - Must also exercise good judgment
  - ❖ Results in a very narrow range of protection and therefore disclosure may jeopardize careers
- **Leading cases: Fraser (SCC 1985), Haydon #1 (FCTD 2001), Haydon #2 (FCA 2005),**

# Whistleblower Legislation in Canada

- **Historical provisions in the Criminal Code include:**
  - ❖ Complaints made in good faith and reasonable belief to police are given certain protections
  - ❖ In some cases identity of witnesses cannot be published (s. 486(3) and (4))
  - ❖ Young complainants can testify behind a screen (s.486 (2.1-2))
  - ❖ Intimidating/interfering with a complainant or witness may constitute obstruction of justice (s. 139) (deemed to be if attempt to dissuade by threats, bribes or other corrupt means)
- **Other existing provisions (note: not Bank Act, CBCA, financial institution legislation or securities legislation)**
  - ❖ Competition Act (Canada) 1999 amendments
  - ❖ Canada Labour Code
  - ❖ Canadian Environmental Protection Act
  - ❖ Canadian Human Rights Act
  - ❖ PIPEDA
  - ❖ Ont. Occupational Health and Safety Act
  - ❖ Ont. Labour Relations Act
  - ❖ Ont. Human Rights Code
  - ❖ Ont. Environmental Protection Act (s. 174(2))
  - ❖ Ont. Public Service Act

# Whistleblower Legislation is Not Uniform

- **Contrast Ontario's *Environmental Protection Act* with U.S. *Sarbanes-Oxley Act*** ( see “Securities Law Whistleblowing” below)
  - ❖ Ontario employers have the burden of persuasion throughout, whereas company facing a SOX complaint need only refute the allegations after the employee establishes a *prima facie* case
  - ❖ Ontario employers must prove that decisions affecting employees are not motivated in any way by the employee's whistleblowing activity (i.e. no improper motive rather than predominant motive), whereas SOX defendant need only prove that it would have taken the same action regardless of WB
    - For this reason documentary evidence, particularly performance reviews, is key – see for e.g. *Stockholm v. Regional Municipality of York*, O.L.R.B. 2002

# Example of Protection: PIPEDA

- **Breach is a an indictable criminal offence (s. 28) including fines of up to \$100,000**
  - ❖ Includes damages for “humiliation”
  - ❖ Possibility of class actions if widespread breach affecting many in same way
- **Cannot “dismiss, suspend, demote, discipline, harass or otherwise disadvantage” an employee if they “in good faith and on the basis of reasonable belief”:**
  - ❖ Disclose to the Commissioner or anyone else that organization has or plans to contravene PIPEDA
  - ❖ Refuse to do anything which is a violation of PIPEDA
  - ❖ Do anything which is required to be done in order to prevent a breach of PIPEDA (such as prevent a co-worker from doing something)
- **Must educate supervisors and middle managers**
  - ❖ Worry re employees making themselves layoff/firing-proof
  - ❖ Be very sensitive to “inadvertent” retaliation
  - ❖ Worry re inadvertent whistleblowing – who gets interviewed by government investigators in the event of an environmental spill or job accident and what do they offer by way of background regarding company’s culture/preventative measures, etc.

# Whistleblower Legislation in Canada

- After numerous attempts to introduce a public sector whistleblower protection statute from 1993 – 2002 (most recently Bill C-6 Oct. 2002), Criminal Code amendments (new section 425.1 effective September 15, 2004) create an indictable offence (up to 5 years imprisonment) for persons acting on behalf of an employer to discipline, demote, terminate or otherwise adversely affect the employment as a result of the employee reporting or proposing to report to the government or a regulator or enforcement authorities a breach of federal or provincial law.
  - ❖ Not to media, stock analysts, internal officials, etc.
  - ❖ Not re breach of company policies or Code of Ethics
  - ❖ Former employees who signed confidentiality agreements not protected
  - ❖ Employees of suppliers, customers, partners not protected
  - ❖ Mere “belief” required on the part of the employee that he is correct – need not be “reasonable” belief or good faith

# Civil Remedies for the Whistleblower

- **As of November 2005 only New Brunswick and Saskatchewan have general Employment Standards specific redress for employees (public and private) who have suffered workplace retaliation for complying with, or reporting violations of, any law**
- **A May 2005 online survey conducted by National Post/COMPAS (in conjunction with the Canadian Chamber of Commerce) found that a majority of senior business leaders of primarily small and medium sized businesses would approved of a specific civil remedy (like S-OX), but not gain-sharing (like US False Claims Act)**
  - ❖ **Greatest need for protection was perceived to be that of public sector employees**

# Importance of Following Specific Legislative Protection

- ***Linda Merk v. International Association of Bridge, Structural, Ornamental and Reinforcing Iron Workers, Local 771***
  - ❖ Former bookkeeper of a Regina union local brought a private prosecution under s. 74 of Saskatchewan's *Labour Standards Act*
    - Protects against retaliation "for reporting or proposing to report to a lawful authority" a breach of federal or provincial law
  - ❖ Saskatchewan Court of Appeal ruled against her, as report was made to president of international union before report was made to police
  - ❖ Case heard by Supreme Court of Canada February 10, 2005
    - Judgment expected shortly

# Whistleblowing Protection for Civil Servants

- Fall of 2001 the federal government establishes the Office of the Integrity Officer, which administers the *“Policy on the Internal Disclosure of Information Concerning Wrongdoing in the Workplace”*
  - ❖ For federal public servants reporting : (a) violation of any law/regulation; (b) misuse of public funds/assets; (c) gross mismanagement; or (d) substantial and specific danger to life, health and safety of Canadians or the environment
  - ❖ Each federal department must have an office responsible to receive and pursue disclosures
  - ❖ Firing offence to retaliate or to disclose in a non-approved manner
  - ❖ Integrity Officer is available if employee cannot go to own department or if complaint not dealt with
    - Power to investigate and make recommendations to deputy head of the department or to President of the Privy Council
    - Can review alleged discriminatory acts
    - Professor Keyserlingk’s first annual report recommends holistic legislative solution due to scepticism (re independence) and lack of worker confidence in policy approach
      - Has the support of PSAC; Nova Scotia government employees union lobbying NS gov’t for similar approach
    - September 2004: Keyserlingk calls for federal government to hand out whistle-blowing awards

# Whistleblower Protection for Civil Servants

- **As part of investigation of federal government sponsorship scandal by Commons Public Accounts Committee, Treasury Board President Reg Alcock offered an informal whistleblowing protection to federal government civil servants who testify**
  - ❖ 1998-1999 three Health Canada scientists had to go to press to get attention of appalling irregularities in drug approval process for bovine growth hormone
    - Alleged producer offered up to \$2 million for swift approval of drug
    - 3 WB's offices burgled, files stolen, reprimanded and suspended - Had to go to Federal Court to protect themselves from sanctions for having gone public – alleged Bureau of Veterinary Drugs used pressure tactics to get them to approve use of certain antibiotics and hormones
    - Won judicial review of decision of Associate Deputy Minister of Health Canada rejection of grievance against letter of reprimand (Haydon v. Q. [2001] 2 F.C. 82)
  - ❖ W-5 expose aired March 27, 2004 concerning Hong Kong visa scandal and RCMP Corporal Robert Read
    - WB went public after encountering roadblocks in investigations
    - RCMP External Review Committee vindicated him but RCMP Commissioner upheld firing
    - Read lost appeal to FCTD June 2, 2005 [2005 FC 798]

# Whistleblower Protection for Civil Servants

- **Joanna Gualtieri (real estate analyst working for Dept. of Foreign Affairs)**
  - ❖ Responsible for a portfolio of diplomatic properties
  - ❖ Objected to lavish spending and spending on rarely used properties
    - Complained internally for 6 years before becoming a whistleblower
    - Made to feel unwelcome and finally went on unpaid leave before quitting
  - ❖ Went on to found the Federal Accountability Initiative for Reform
- **Jon Grant (former Chair of Canada Lands Corp.) went public with concerns about meddling by then Minister Gagliano**
- **Bernard Dussault (chief actuary, Canada Pension Plan) was asked to modify numbers to paint a better picture of CPP – was fired**
- **Dr. Michele Brill-Edwards (senior physician responsible for drug approvals at Health Canada) driven to resign in 1996 and subsequently won a Federal Court case**
- **July 2004 firing of three Health Canada scientists for history of “insubordination” (late 1990’s complaints lead to Senate investigation and decision not to approve bovine growth hormone; then criticized Health Canada’s strategy to fight mad cow disease – lost judicial review *Haydon v. Canada (Treasury Board)* 2005 FCA 249 (CanLII))**
- **Many other cases referred to in Hansard debate (2002, 37<sup>th</sup> Parliament, second session, Number 053 (1730)) over Bill C-201 (a then proposed private members’ bill to protect civil service whistleblowers)**

# Canadian Law on Civil Servant Protection

- **2003 House of Commons committee report into the tenure of George Radwanski as Privacy Commissioner also called for better protection of whistleblowers**
  - ❖ Auditor General report re Radwanski abuse of taxpayer funds on foreign trips, restaurants and hiring practices also reiterated climate of fear and need for robust whistleblower protection
- **Following Integrity Officer recommendation for a holistic legislative solution, Treasury Board established a working group to review the state of internal disclosure protection in the Public Service of Canada**
  - ❖ Report released January 2004
  - ❖ Recommends a holistic legislative approach including whistleblowing protection and measures designed to create supportive values-based working environments where “rightdoing” is promoted
  - ❖ A new independent agency headed by an Official of Parliament
  - ❖ Leadership development, screening and selection of senior appointments and performance management
- **Bill C-25 (37<sup>th</sup> Parliament, 32<sup>rd</sup> session) introduced March 22, 2004 (referred to House of Commons committee April 20, 2004 – died on the Order Paper with dissolution of Parliament)**
  - ❖ Did not cover all departments (RCMP, CSIS, Defence, cabinet ministers)
  - ❖ Requires whistleblowers, with some exceptions, to make disclosure through government channels (2003 Public Service Modernization Act already precluded access to courts); Breach of Treasury Board rules not included in reportable events
  - ❖ Can be disciplined/sanctioned if don't follow reporting protocol or if a disclosure is “frivolous or vexatious or in bad faith”
- **Federal Parliament Ethics Officer appointed April 2004**

Brian Ludmer, Nov. 2005

# Canadian Law on Civil Servant Protection

- **October 2004 announcement of enhancements to proposed Public Servants Disclosure Protection Act (Bill C-11 passed by House of Commons Oct. 8, 2005 and second reading in Senate October 27, 2005)**
  1. Reports go to an independent agency
  2. Third party to have greater investigative powers, including gathering documents and subpoenaing witnesses
  3. Amendments to Access to Information Act to protect confidentiality
  4. Retroactive protection to February 2004 to cover sponsorship scandal disclosures
  5. Time period to complain extended to 60 days from 30
  6. Crown corporations included
    - ❖ RCMP, CSIS and Armed Forces excluded, but required to establish similar disclosure regimes and codes of conduct
- ❖ **Proposed legislation criticized by whistleblower Allan Cutler due to: imposing burden of proof on employee; prohibiting talking to the media except in prescribed circumstances; failing to provide paid counsel to employee; failure to cover contract employees; ability to exempt out Crown corporations**

# Canadian Law on Civil Servant Protection

- Frequent allegations of political interference explored in *“Speaking Truth to Power”* in *Nexus* (U of T Faculty of Law) fall/winter 2004 p. 32
- July 2005 arbitrator decision in favour of Canada Post employee in Montreal who exposed “shift-selling” (*“Reinstate whistleblower carrier, Canada Post told”*, National Post, July 20, 2005, p. A2)
- Conversely: see *“Corrupt staff go unpunished, Gomery says”* National Post date unknown)

# INTERNATIONAL WHISTLEBLOWING

Brian Ludmer, Nov. 2005

# International Whistleblowing

- ***“Whistleblower Hotlines put global firms in legal bind”***, **Globe and Mail, September 6, 2005**

- ❖ McDonalds and Exide Technologies told by France’s Data protection Authority (CNIL) that their planned ethics hotlines in France were illegal
- ❖ Had been attempting to comply with S-OX
- ❖ CNIL has written to SEC about the problem
  - Reconciling anonymous tips with accused’s privacy rights
- ❖ France’s laws based on EU Data Protection Protocol, but being interpreted differently than in other EU countries, such as UK where Information Commissioner’s Office sees no problem so long as investigation properly conducted impartially

# INTERNATIONAL WHISTLEBLOWING

- **OECD Multinational Enterprise Guidelines (June 2002) re good corporate behaviour provides that enterprises should:**
  - ❖ “refrain from discriminatory or disciplinary action against employees who make bona fide reports to management or, as appropriate, to the competent public authorities, on practices that contravene the law, the Guidelines or the enterprises’ policies”
- **Article 22 of the Council of Europe’s Criminal Law Convention on Corruption *obliges* member states to provide “effective and appropriate” protection for whistleblowers in their domestic laws**
- **OECD Principles of Corporate Governance and 1999 Universal Code of Corporate Conduct**

# INTERNATIONAL WHISTLEBLOWING

- **North American Agreement on Environmental Cooperation**
  - ❖ Citizen complaints to admin body
- **Article III, s. 8 of The Inter-American Convention Against Corruption requires signatories to *consider* creating, monitoring and strengthening “systems for protecting public servants and private citizens who in good faith report acts of corruption, including protection of their identities...”**
  - ❖ Article 43 of March 2003 draft of UN Convention against Corruption is similar
- **European Commission has not mandated whistleblower obligations on member states but does impose a duty on its own employees to report concerns about serious wrongdoings and managers have a duty to follow-up. Also protections against retaliation if disclosure made in good faith**

# INTERNATIONAL WHISTLEBLOWING

- **1999 revelations by Paul van Buitenen, a Dutch European Commission accountant, concerning lax spending controls (including disappearance of 60 million euros from an aid programme) led to resignations of all 20 commission members**
  - ❖ Knighted by Queen Beatrix
  - ❖ Leads a single issue (EC accountability) Dutch political party and recently elected
  - ❖ Recently stated that EC still does not adequately trace where its US\$121 billion budget goes
- **Transparency International 2004 Integrity Awards recognized a bank clerk at Kenya's Central bank and a former head of the tax department in the ethnic Serbian part of Bosnia**
  - ❖ Posthumous awards given to three who lost their lives
    - Turkish electrical engineer re corruption in state electricity company
    - Indian killed after making a complaint about corruption in a road-building project he was overseeing
    - Bangladeshi journalist
- **Gui Xien, a doctor who in 1999 stumbled on a rural China AIDS epidemic overcame resistance from provincial health authorities and sent a report directly to Beijing – local officials targeting him with a smear campaign and physical threats**

# INTERNATIONAL WHISTLEBLOWING

- **UK Public Interest Disclosure Act of 1999 provides protection for both public and private sector employees with respect to disclosures made in good faith**
  - ❖ Applies to concerns raised internally or to prescribed senior government officials
  - ❖ Wider disclosure (media, police, etc.) protected if “reasonable” and where the matter:
    - Is exceptionally serious;
    - Is not raised internally or to prescribed regulator because fear of victimization or that there would be a cover-up or there is no prescribed person;
    - Was raised internally or with a prescribed person but was not dealt with properly

# SECURITIES LAW AND WHISTLEBLOWING

Brian Ludmer, Nov. 2005

# Securities Law Whistleblowing

## ▪ COSO Framework – Evaluation of entity level controls (selected excerpts)

### ❖ Control environment

- Key executive integrity, ethics and behavior
- Audit Committee oversight
- Organizational structure, authority and responsibility
- HR policies and procedures

### ❖ Risk assessment

- Mechanisms to anticipate, identify and react to significant events

### ❖ Information and communication

- Established communication channels for employees to fulfill responsibilities

### ❖ Control activities

- Existence of necessary policies and procedures

### ❖ Monitoring

- Internal audit function established to monitor activities

# Securities Law Whistleblowing

## ▪ PCAOB Audit Standard No. 2

- ❖ Management obligation to institute (auditor to independently assess) fraud control programs (detection and prevention)
- ❖ Para. 17 benchmark for “effective” ICFR: material misstatements prevented or detected on a timely basis
- ❖ Indicated examples of conditions that are at least “significant deficiencies” as well as strong indicators of a “material weakness”:
  - Ineffective oversight by audit committee
  - Identification by auditor of material misstatement not caught by company
  - Ineffective control environment
  - Significant deficiencies that have been communicated but not rectified by management within a reasonable period of time
  - Senior management fraud
  - Ineffective regulatory compliance function

## ▪ New CICA Assurance Standard “Reporting on Internal Control over Financial Reporting” is similar

# Securities Law Whistleblowing

- **February 2004 KPMG survey of directors of 75 large Canadian Cos.**
  - ❖ Accounting fraud “possible” (27%); risk unknown (19%)
  - ❖ 72% of directors mostly rely on outside auditors to find fraud, yet only 3-5% of frauds found by external auditors
  - ❖ Accounting and disclosure cases indicate that “someone in the organization always knows”
- **SEC Audit Committee rules (33-8220) require the implementation of a confidential reporting pipeline (S-OX s. 301)**
- **SEC Rule 204A-1 under Investment Advisers Act issued July 2004 requiring all investment advisers subject to SEC jurisdiction to adopt and enforce codes of ethics setting forth standards of conduct for advisory personnel and to address conflicts arising from personal trading by advisory personnel**
- **NASD Rule 3013 (effective Sept. 2004) requiring CEO of broker-dealers to certify compliance program and requiring Chief Compliance Officer**
- **34’ Act sec. 10A (added 1995 PSLRA) requires external auditor to report information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred to the appropriate level of the management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such a committee, is adequately informed**
  - ❖ If timely and appropriate remedial action is not taken, obligated to report to Board
  - ❖ Board required to notify SEC within one day and copy accounting firm, failing which accounting firm must notify the SEC
  - ❖ Only 29 filed to May 15, 2003
  - ❖ Similar provisions for auditors in financial institutions legislation

**Brian Ludmer, Nov. 2005**

# SEC Bounty-Hunter Program

- **Established 1988**
- **Legislative authority only applies in respect of insider trading and not other securities laws**
- **Bounty limited to 10% of penalty levied against offender, but otherwise subject to SEC discretion as to what amount, if any, is paid**
  - ❖ Only three bounties paid out in history of program to 2004
  - ❖ 2001: total of US\$18,000
  - ❖ 2002: total of US\$29,079
- **Concern re required disclosure to SEC of identity of tipster**

# Whistleblower Provisions of S-OX

- **Designed to shield employees from retaliation when they provide information (to federal government/enforcement agency/supervisory employee/investigating body of employer in a related proceeding) they “reasonably believe” to be a violation of U.S. federal securities law, federal mail, wire and bank fraud statutes, the Rules of the SEC or “any federal law relating to fraud against shareholders” (not just securities law)**
- **Integrated approach would have protected Sherron Watkins:**
  - ❖ Prohibits retaliation (firing, verbal threats, missed promotions etc.) (s. 806 and s. 1107)
  - ❖ Solicits, encourages and reinforces whistleblowing (s.301 re audit committees procedure)
  - ❖ Requires adoption of corporate code of ethics for senior financial officers (s. 406)
  - ❖ Process to receive, review and solicit reports concerning fraud and ethical violations
  - ❖ Administrative, civil and criminal sanctions

# Whistleblower Provisions of S-OX

- **Who is covered: public companies and officers, employees, subcontractors and agents**
  - ❖ Certain provisions apply to private companies (s.1107)
  - ❖ Whistleblower burdens placed on in-house and external counsel
- **What acts protected: (effective July 2002)**
  - ❖ S. 806 of S-OX creates (for 34' Act filers) a civil cause of action in favour of employees of the company, contractors/subcontractors facing retaliation (broad term) for “covered acts” (securities fraud and related crimes)
    - Policies that protect against liability under s. 806 would, in large part, be the same as that satisfying the complaint procedure requirement of s. 301 and the code of ethics requirement in s. 406
  - ❖ S. 1107 of S-OX (fines of up to US\$250K for individuals and US\$500K for organizations and up to 10 year sentence for “knowing” retaliation – defined even broader than for s.806) applies to public and private situations, also applies to non-employees, for any federal law, but only re reports to law enforcement officers - No protection for speaking to the press or within the company – Specifically intended to have extraterritorial effect (i.e. not limited to US companies or domestic activity)
  - ❖ Unlike most other federal WB statutes, S-OX holds individual executives, agents and supervisors personally liable for unlawful retaliation and makes retaliation a felony offence

## Process: File a complaint with Department of Labour (OHSA) within 90 days of the “retaliation”

- ❖ 228 complaints filed Aug 2002 to April 15, 2004
  - However DOL given no new resources and has no subpoena power and no authority to interview employees without a company representative present
- ❖ 119 reported decisions by Administrative Judges through February 7, 2005
  - <http://www.oalj.dol.gov/public/wblower/refrnc/sox1list.htm>
    - Early issues: employees of private subsidiaries; foreign employees; scope of covered activity, jurisdiction over foreign “pink sheet” issuers
- ❖ OHSA published in August 24, 2004 Federal Register a final rule establishing procedures for handling whistleblower complaints  
[www.osha.gov/pls/oshaweb/owadisp.show\\_document?p\\_table=FEDERAL\\_REGISTER&p\\_id=18223](http://www.osha.gov/pls/oshaweb/owadisp.show_document?p_table=FEDERAL_REGISTER&p_id=18223)
- ❖ After 6 months without a decision, can demand a jury trial in federal court
  - Employee must prove WB activity was a contributing factor to the retaliation – then burden shifts to employer to demonstrate by clear and convincing evidence that it would have taken same action (e.g. dismissal) in any event
  - JDS Uniphase was first decision
  - Hard to link more subtle forms of retaliation to disclosure and damage award will depend on the facts – promotions lost and re-employability
  - Cannot win punitive damages and uncertain re emotional distress claims
- ❖ Administrative remedies (against company and individual employees): reinstatement, back pay, interest, expenses, compensatory and special damages
  - No financial incentives – unlike FCA; Cannot correct the allegations or have the wrongdoer fired
  - First decision January 2004 re Cardinal Bankshares Corp. (Floyd, Virginia) ordered to rehire CFO with back pay (a tough environment on return)
    - Allegations related to accounting, insider trading and internal controls
    - Had been fired for requesting his own lawyer be present when he was interviewed by company about allegations

# Applicability of SOX s. 806 to Non-US Employees

- ***Carnero v. Boston Scientific***, a U.S. district court decision dated August 27, 2004 ([http://www.oalj.dol.gov/public/wblower/decsn/04\\_10031.pdf](http://www.oalj.dol.gov/public/wblower/decsn/04_10031.pdf))
  - ❖ Court found that Section 806 protections do not apply to a foreign national who works exclusively overseas
  - ❖ Neither *Carnero* nor the final OSHA regulations explicitly address the application of Section 806 to U.S. citizens who are employed abroad
  - ❖ Nevertheless, the decision in *Carnero* states that OSHA made a preliminary determination on December 19, 2003 that it lacks jurisdiction in the matter because “nothing in the language of [Section 806] indicates any intention by Congress to cover employees working outside of the United States”
    - Ultimately, OSHA did not issue a final decision within the statutory 180-day administrative waiting period, the employee pursued his claim in the district court and OSHA dismissed the administrative complaint because of the district court proceeding (<http://www.oalj.dol.gov/public/wblower/decsn/04sox18a.htm>)
    - The release accompanying the final OSHA regulations states that "the rule is not intended to provide statutory interpretations."

# Canadian Securities Law Whistleblowing

## ▪ CSA Multilateral Instrument 52-110 – Audit Committees

- ❖ S.2.3(7) requires the audit committee to establish procedures for:
  - The receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters
  - By 1<sup>st</sup> annual mtg. after July 2004 (no later than July 2005)
- ❖ This requirement applies to TSX Venture Exchange companies because the exemptions for them cover only other parts of the Instrument
- ❖ British Columbia pursuing its own “model”
- ❖ Certain issuers are exempted from the Rule:
  - *(a) investment funds; (b) issuers of asset-backed securities; (c) designated foreign issuers; (d) SEC foreign issuers; (e) certain debt/preferred share issuers that are subsidiary entities; (f) certain exchangeable security issuers; and (g) certain credit support issuers*

# Canadian Securities Law Whistleblowing

- **Note that MI 52-109 Certification requirements likely require a broader whistleblowing infrastructure**
  - ❖ Consistently during the 17 year history of United Technology's Dialogue Program (confidential reporting to Ombudsman) only about 5% of complaints relate to financial reporting
  - ❖ If you take care of the small complaints, you create an environment which might prevent the larger offences
  - ❖ Oct. 2003 report on proposed amendments to US Federal Sentencing Guidelines: "directors and officers have an obligation to become informed about the accuracy and timeliness of the compliance reporting systems within their organizations in order to reach informed judgments about compliance with the law"

# Securities Law Whistleblowing - Lawyers

- **SEC attorney “up-the-ladder” reporting obligations re “material breach of securities law or breach of fiduciary duty or similar violation of law” (S-OX s. 307 and SEC Release 33-8185) and draft “noisy withdrawal proposal” (33-8186)**
  - ❖ Spiegel Inc. Bankruptcy Examiner report (client failed to follow advice and lawyer stopped asking)
  - ❖ Kaye Scholer US\$41 million and Jones Day US\$51 million settlements with Office of Thrift Supervision re knowledge of “material facts” re Lincoln Savings
  - ❖ Internal and external counsel cannot sit still and claim privilege (state and provincial professional conduct rules differ)
  - ❖ Rite Aid’s Chief Counsel convicted 2003 of conspiracy, witness tampering and other charges related to inflated earnings (allegations of backdating severance letters and misleading internal and external auditors and federal investigators)
  - ❖ 2004 Settlement with John Isselmann, general counsel of a small tech company, was among first prosecutions
    - Accused of passive knowledge of planned aggressive accounting and failing to advise auditors or audit committee.
    - Fined U.S.\$50,000

# Securities Law Whistleblowing - Lawyers

- ❖ Securities law “aiding and abetting” or primary actor liability (gatekeeper issue)
  - SEC powers under Rule 102(e) of SEC’s Rules of Practice to prohibit lawyers from providing services to a registrant
  - 2002 Enron decision permitting “secondary actor” claims against lawyers
  - *Securities Act* (Ontario) s.122 re misleading statements to the Commission
  - *Securities Act* (Ontario) s. 126.2 re misleading statements to the market
  - OSC’s 1992 proposals for power to prohibit advisors from being retained by registrants or reporting issuers
  - OSC enforcement actions against lawyers
  - US DOJ prosecutions against “gatekeepers”
    - See: “*Deals and Consequences*” nytimes.com, Nov. 20, 2005 regarding Merrill Lynch bankers and Enron Nigerian barge transaction

# Securities Law Whistleblowing - Lawyers

- ❖ Professional Conduct Rules had not “required” Board reporting (it was a permitted practice under ABA Model Rule of Professional Conduct) but did confirm that the “client” is the corporation (ABA Rule 1.13(b)) and allow for attorneys to hire a separate legal opinion
  - Jordan Mintz, Enron counsel, secretly hired Fried Frank (NY) re Skilling’s not signing documents and re accounting for OBS entities – but did not send their report to the Board
  - ABA rules further softened Aug. 2003 to allow, and in some cases compel, “reporting up” and to permit “reporting out” if believed necessary to prevent fraud or crime that would cause financial harm (previously only permitted to prevent physical injury or death) – but ABA rules require adoption by state bar associations
- ❖ Professional Conduct Rules often conflict with proposed external reporting
  - New York would not allow; Connecticut would; Washington State Bar reaffirmed prohibition
  - Canadian Bar Association submission Dec. 13, 2002
- ❖ Recent change to LSUC Rules of Professional Conduct (Rules 2.02(5.1)+(5.2)) requires “up-the-ladder” reporting to senior management and, if necessary, to the Board
  - If advice ignored and dishonest, fraudulent, criminal or illegal conduct involved, must resign from the particular matter (circumstances determine whether can retain other mandates)
  - No “deemed knowledge”, but query “wilful blindness”
  - Not required to report to regulators
  - LSUC Rule 2.02(1.1) confirms that lawyers’ duties are owed to the organization, not instructing officer

# Securities Law Whistleblowing - Lawyers

- ***“Get the Wrong Answer, Ask Another Lawyer”***,  
*(New York Times, November 21, 2004, p.4)*
  - ❖ *TV Azteca*, a Mexican firm whose shares trade on NYSE, cycled through three large US law firms seeking an opinion that transactions by CEO and a partner resulting in a US\$218 million profit from buying company debt at a deep discount and selling it back to the company did not have to be disclosed
  - ❖ Akin Gump partner complained to the board
    - *Led to an independent committee retaining a fourth independent firm to make recommendations after canvassing all facts*
  - ❖ SEC plans to file civil complaint against four officers and the company for improper disclosure

# Complying with the Whistleblower Provisions of Securities Law

- **Create an Open-Door Policy for reports of fraud**
- **Audit committee required to establish a confidential and anonymous complaint and investigation protocol**
- **Create an Ethics and Conflict-of-Interest Policy (s. 406)**
- **Publicize policy prohibiting retaliation and monitor compliance**
- **Create or amend Document Retention Policy (ss. 802 and 1102)**
  - ❖ Auditor record keeping: SEC Release 33-8180
- **Train employees about complaint procedures and company's anti-retaliation commitment**
- **Check insurance coverage**
- **Consider complaint notification system outsourcers**

# ISSUES IN LEGISLATIVE AND SYSTEM DESIGN

# SOME ISSUES WITH ANY SYSTEM

- **Mistaken claims brought in good faith based on limited information (“red flags” but no “smoking gun”)**

- ❖ Ensure communication of conclusions to avoid perception of cover-up
- ❖ Through mid-April 2004, 80% of SOX *False Claims Act* cases were dismissed by OSHA investigators – but mostly for legal issues (statute doesn’t apply retroactively, 90 day notice period issues, covered acts, etc.)
- ❖ Over 75% of cases brought each year are found to lack merit (2002 FCA)

- **Legitimate grievances having nothing to do with breach of laws or company’s code of conduct attempted to be resolved using leverage of whistleblowing system**

- ❖ Promotion, compensation and other job-related disputes should be handled by HR or union (re collective agreement) and employees educated

- **Process abused**

- ❖ Invent or exaggerate to try and pre-empt lay-off (law does not require reasonable belief based on compelling evidence)
- ❖ Escalate a legitimate policy dispute (mine safety official currently battling with US government over environmental cleanup)
- ❖ Sit on an issue to make a *Qui Tam* claim

- **Claim screeners need training**

- ❖ Particularly hard with anonymous allegations
- ❖ Accused employees entitled to fairness as well

# SOME ISSUES WITH ANY SYSTEM

- **Should we require (and should Sherron Watkins have) reporting up the chain by employees and should we require external whistleblowing?**
  - ❖ Ms. Watkins accused of not blowing the whistle externally in order to continue to sell stock in Enron
  - ❖ In fact she had reported to the CEO and was told he was going to take action
  - ❖ She expressed fears for 20,000 employees who might be hurt and not wanting to be responsible for the demise of the company (common concern)
  - ❖ Wanted to give the company time and opportunity to fix itself
  - ❖ Only regret was that she didn't go to the Board
    - In fact the Board had received briefs on the accounting issues as early as 1999

# Policy Disputes Masquerading as Whistleblower Disclosure

- **1970's Daniel Ellsberg – Pentagon Papers/ 2004 Paul O'Neill and Bush**
- **US government lawyer who leaked government's UN debt policy to Congressional Republicans**
- **Hugh Kaufman of US Dept of Environment described as:**
  - ❖ “a long-time gadfly and media ham whose thirst for publicity is exceeded only by his emotional and somewhat loose grip on the facts”
- **Elaine Mittleman - Treasury Officer responsible for Chrysler, Penn Central, Lockheed and NYC bailouts**
- **Vincent Laubaugh – Interior Department outstanding orders re strip mines**
- **Military officers subpoenaed to give testimony re Iraq**
- **Health Canada microbiologist suspended for criticising government policy re animal feed ban**
- **Saskatoon Royal University Hospital emergency room doctor wrote to Health Minister about understaffing**
  - ❖ Letter leaked and he was dismissed for failure to follow proper channels and for inflammatory and unsubstantiated allegations

# Policy Disputes Masquerading as Whistleblower Disclosure

- **CIA permanent bureaucracy vs. “Dubya” and new CIA Director Porter Goss**

- ❖ *“In Your Face at the CIA”*, Time, November 29, 2004

- **Remember debate concerning US legislation for Federal civil servant protection:**

- ❖ Retaliatory acts prohibited in respect of “disclosures” of information the employee reasonably believes is evidence of “gross mismanagement, a gross waste of funds, an abuse of authority or a substantial and specific danger to public health or safety”

- ❖ “covered position” excludes positions: ... “ excepted from the competitive service because of its confidential, policy-determining, policy-making, or policy-advocating character”

- ❖ How would this apply in the context of a private company?

# Issues in Whistleblower Legislation

- **Law is still largely undeveloped due to lack of consensus on threshold issue of what matters deserve protection and how to provide due process for accused**
  - ❖ Significant mischief results if report is untrue or reported to wrong place
    - Urquhart complaint against iTCanada.com – not being investigated by OSC
  - ❖ Are the timing and motives of the whistleblower relevant?
  - ❖ Is motivation (embarrassment, vindictiveness, self-interest (e.g. *Qui Tam*), self-preservation) relevant?
  - ❖ Should first report go to the wrongdoer or may it go to the government?
  - ❖ Is there a distinction between public sector or private sector?
  - ❖ What if the whistleblower is acting out of a right or duty?
  - ❖ Are other non-disclosure efforts relevant?
  - ❖ How much proof is required for discloser to obtain protection?
  - ❖ What kind of protection? Immunity from private lawsuits (defamation), no retaliation, privacy, reimbursement of personal costs, others?
    - US public sector legn. even awards bonus
  - ❖ Admin. Involvement: what powers, what duty?
  - ❖ Role of anonymity (can breed fear, anger and intimidation among workers)
    - False accusations as a tool for disgruntled workers
    - Orwellian overtones

# IMPLEMENTING A WHISTLEBLOWING SYSTEM

# The Securities Law Requirements

- **SEC Audit Committee rules (33-8220) require the implementation of a confidential reporting pipeline (S-OX s. 301)**
  - ❖ No specific procedures mandated: “Given the variety of listed issuers in the U.S. capital markets, we believe companies should be provided with flexibility to develop and utilize procedures appropriate for their circumstances.”
  - ❖ By earlier of 1<sup>st</sup> annual meeting after January 15, 2004 or October 31, 2004
    - July 31, 2005 for foreign private issuers and small business issuers
  - ❖ SEC says good practice to post procedures on website
- **CSA Multilateral Instrument 52-110 – Audit Committees**
  - ❖ S.2.3(7) requires the audit committee to establish procedures for:
    - The receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters
    - No specific procedures mandated
    - By 1<sup>st</sup> annual mtg. after July 2004 (no later than July 2005)

# Non-Employee Reports

- **SEC Rule 33-8220: Standards Relating to Listed Company Audit Committees**
  - ❖ “While the scope of the requirements generally includes complaints received by a listed issuer regardless of source, Exchange Act Section 10A(m)(4)(B) and the relevant portion of the rules referring to confidential, anonymous submission of concerns are directed to employees of the issuer.”
- **MULTILATERAL INSTRUMENT 52-110 Audit Committees is similar**
- **Most companies do not make confidential and anonymous system available to third parties**
  - ❖ See Cognos website for one company that does

# Getting Buy-In for a Robust External Infrastructure

- **Responding to typical objections:**

- ❖ *“Our hotline to the Audit Committee Chair works – we get very few calls”*
- ❖ *We have a very ethical and collegial corporate culture and don’t want to upset that with a “snitch” line that could create an “Orwellian” environment*
- ❖ *Implementing a robust system would be like admitting to the world that we have problems*
- ❖ *We’ll get to it eventually*
- ❖ *We’re a small company – we all know what’s going on*

- **Responses:**

- ❖ *Complementary process*
- ❖ *Creates an audit trail*
- ❖ *Perceived independence will bring out latent issues*
- ❖ *Ability to follow-up with questions while maintaining anonymity*
- ❖ *Full-time 24 hour coverage (audit committee is part-time)*

# Getting Started

- **Understand what you have in place already and relevant benchmarks and legal requirements**
  - ❖ Most companies have some sort of conflicts/ethics/fraud/misuse of assets protocols
  - ❖ Consultant studies re compliance issues
  - ❖ Existing codes of conduct, compliance manuals, documentation of waivers
  - ❖ Copies of risk assessments
  - ❖ External audit management letters and internal audit reports
  - ❖ Interviews with senior management and compliance/audit officers
  - ❖ Benchmark existing practices against requirements for corporate sentencing guidelines and credit for cooperation policies

# Implementing Whistleblower Pipelines

- **Building on clear policy for internal reporting of breaches of company policy is the need for a roadmap for reporting:**
  - ❖ Need several available reporting channels within the business unit and enterprise to avoid reporting through superiors or colleagues suspected of participating
    - If matter stalls, alternative channel available
  - ❖ Allow for anonymous reporting and confidentiality
    - Cannot be guaranteed due to requirement to consult senior management, outside advisors and government officials
    - Nortel's experience since 1990 is that only 1% request anonymity
  - ❖ Differentiation among problems raised and appropriate process constructed to investigate/solve each
    - independence, capacity, expertise; discrete, professional and fair
    - Understanding of human nature; interviewing skills
  - ❖ Provide feedback to whistleblower about outcome of investigation
  - ❖ Comply with all governmental notice requirements
  - ❖ Prohibit retaliation in any form

# Implementing Whistleblowing Pipelines

- Remember, the goal is to encourage reporting, in good faith, after the employee has exhausted normal channels
  - ❖ Don't require “reasonable basis” or impose sanctions for “frivolous” matters
    - Employee self-censorship will deter reporting
  - ❖ Do *strongly encourage* that the employee first:
    - Try to convince their direct report and at least one indirect report within their business unit (unless they have a good faith fear of retaliation)
    - Then try another internal channel (such as Chief of Internal Audit or Chief Legal Officer or corporate ombudsman), that they would consider independent (unless they have a good faith fear of retaliation)
  - ❖ Formal whistleblowing channel should be open for use without fear of being accused of wasting time and money, but should be viewed as a “final option”
    - Many business decisions provoke heated debate internally and employees must learn to get along, work things out and convince each other of the strength of their arguments

# Implementing Whistleblower Pipelines

- **Ensure protection for accused employees (and avoid defamation)**
  - ❖ System should ensure that due process will be followed and confidentiality and dignity of the accused will be maintained as much as possible
  - ❖ No tolerance for unsubstantiated rumours or malicious motivation
  - ❖ Assume they are innocent until proven guilty
  - ❖ Have a formal, published policy on investigations
  - ❖ Focus investigation on what's relevant
  - ❖ Limit the number of people involved
  - ❖ Have trained investigators re employment law and libel/slander (“qualified privilege”)
  - ❖ Get outside help: specialist lawyers, private investigators, police
  - ❖ Document everything
  - ❖ Give accused an opportunity to respond to allegations
  - ❖ See, *“Accused Workers Fight Back”*, Globe and Mail, January 14, 2004, C6

# Design Parameters for a Whistleblowing System

- **Make it accessible to all in a variety of media and easy to use**
  - ❖ Hotlines have been around a long time (employee theft, discrimination, harassment, government contract fraud)
  - ❖ 25% of Enron's reports were by phone; 61% were by email or letter
  - ❖ Web-based system is best given ease and efficiency and record retention and confidentiality (compared to telephone transcription)
    - Smart filters can eliminate certain "CCs".
    - Allows statistical data collection and data mining
    - Can be outsourced so your IT people can't access
    - Enables "alerts" for new submissions and filtering and filing tools
    - Avoids requirement for telephone staff trained in multiple issues and languages
  - ❖ Provide multiple language support for global companies
    - Consider local employment and privacy laws
  - ❖ Design for the type and size of company
- **Respond in a timely manner**
- **Treat the problem - Required for Internal Control and Credit for Cooperation (as well as Bill C-45 and Federal Sentencing Guidelines)**
  - ❖ Determine if it is isolated or systemic
  - ❖ Impose appropriate sanctions
  - ❖ Consider process changes, disclosures, employee training, fraud-prevention efforts, risk-assessment activities and terminations

# Design Parameters for a Whistleblowing System

- **Consider leveraging the investment and infrastructure to capture a broad range of matters**
  - ❖ Government employee legislation covers:
    - Violation of law, rule or regulation
    - Gross waste of funds
    - Gross mismanagement
    - Abuse of authority
    - Substantial and specific danger to public health and safety
  - ❖ Consider also:
    - Breach of corporate ethics policy (implicitly a requirement of Codes of Ethics Rules)
    - Departure from SOX/PCAOB/CICA controls infrastructure
    - Industry-specific matters
      - U.S. healthcare legislation concerns: cost to government; quality of care; access to care; patients' freedom of choice
  - ❖ Statistically, accounting and auditing matters are a small % of matters reported

# Design Parameters for a Whistleblowing System

## ▪ Ensure an Audit trail

- ❖ Record and timestamp and permanently retain all messages and other interactions
  - These may be subpoenaed
  - Essential for admissibility in proceedings
  - May be relevant for SOX 90 day statute of limitations for “retaliation”
- ❖ Be aware of S-OX s.802 recordkeeping requirements
  - All information relevant to the audit or review, including documents and communications that contain conclusions, opinions or financial data related to that review
- ❖ “*SEC Toughening Up on Non-Cooperation*”, CFO.com June 7, 2004
  - Symbol Technologies, Lucent, Bank of America Securities fines reflect SEC attitude toward extent of co-operation in investigation
- ❖ See “*Whose Lawyer Are You Now?*”, National Post, November 24, 2004, which explores the current SEC enforcement environment regarding obstruction of justice charges
- ❖ Must test the system for Internal Control compliance
  - SEC investigating DaimlerChrysler after former hotline administrator was fired allegedly for complaining that matters were suppressed or not investigated
  - See, “*Hotline Suit Pits Whistle-Blower, Daimler Chrysler*”, *The Wall Street Journal*, July 26, 2005, p.A17

## ▪ Have a process, document it and follow it

## ▪ Train employees in how to use the system and get feedback as to whether they view it as independent and convenient

- ❖ Coke’s system indicated that senior management receives the reports
  - Not comforting given Coke’s fight with Whitely

# Design Parameters for a Whistleblowing System

- **Reporting protocols**: how and who receives complaints; where they go; escalation rules
- **Complaint cataloguing protocols**: prioritization rules; filtering for purposes of determining who should deal with it and how it should be reported
- **Investigative protocols**: ensure privilege, confidentiality, avoidance of conflicts of interest, evidence gathering techniques, “need to know”, avoidance of leaks, sensitivity to the accused, employment and privacy law protocols
- **Protective protocols**: S-OX s.806 anti-retaliation procedures
- **Develop a communications and training strategy to encourage reporting**: intranet, pay stubs, performance reviews, formal training, consequences of abusing the system, new employee orientation, annual certification of having read and understood, annual survey about experience with the system and any reservations about reporting

## Design Parameters for a Whistleblowing System

- **Makeup of complaint assessment team (C.A.T.) and advisors: lead by GC, include chief compliance officer and senior HR, chief risk officer, ethics officer/ombudsman, chief security officer**
  - ❖ Audit/investigation techniques may require internal audit and IT to assist re documents, logs and records
  - ❖ Outside counsel and audit committee for special investigations
  - ❖ Minor matters can be delegated to non-conflicted management, with reporting back to the C.A.T.
- **Guidelines needed re communication with external auditors and counsel**
  - ❖ SOX s.302 requires disclosure (to auditor and audit committee) of any fraud, regardless of materiality, involving someone who is a participant in the financial reporting process
  - ❖ PCAOB Std. 2 regarding fraud reporting

# Design Parameters for a Whistleblowing System

- **Maintain good records (see PCAOB Std. 2)**

- ❖ Meetings, actions taken, results of those actions, disposition of all complaints
- ❖ Summary of facts, recommendations and conclusions and direction to management for improvements and censure

- **Conduct a fraud risk-assessment**

- ❖ Industry and geographic – specific risks
- ❖ Review all previous reports of fraud
- ❖ Evaluate existing anti-fraud policies, compliance and enforcement
- ❖ Facilitated meetings with relevant compliance and HR people
- ❖ Get outside expert advice and benchmarking
- ❖ What waivers are granted from ethics and other polices and with what approval and record-keeping process?

# Situating the Organization to Defend Itself Against Retaliation Complaints in Litigation

- Have an anti-retaliation policy in manuals and employee handbooks, train supervisors and enforce vigorously
- Report to accused that company has received complaint and that allegations will be investigated in a neutral and fair manner by an independent party
  - ❖ refer to “allegations” to avoid defamation claims
- Exercise caution when considering a transfer of the WB or accused until final determination
  - ❖ At least have WB report to a new supervisor/manager who is unaware of complaint
- Limit communications to those who “need to know” and have them sign acknowledgement of “anti-retaliation policy”
- Postpone pending layoffs or other “adverse actions” that may have been pending
  - ❖ Ensure an ongoing documentation process (including all employees) of reasons for firing, promotion, discipline and discharge
- Audit trail of management deliberations and actions
- Review all emails and other records as part of the investigation

# Implementing Whistleblower Reporting

## ▪ Deloitte April 2003 survey of Fortune 1000 companies

- ❖ 85% have a system to receive internal complaints (KPMG survey: 22% in 1997; 38% in 1999)
- ❖ 60% have a system to receive external complaints
- ❖ Internally-operated systems: 63% telephone hotline; 31% email; 19% website
- ❖ Third party administered plan: 19% telephone; 3% website; 3% email

## ▪ NIRI November 2003 survey

- ❖ 65% have a S-OX system to receive internal complaints
- ❖ 54% either outsource or plan to do so
  - More than a dozen providers indicated (see Compliance Week for examples:  
<http://www.complianceweek.com/index.cfm?fuseaction=page.viewPage&pageID=104&nodeID=1>)
  - ClearView and DisclosurePlus  and Shareholder.com  have robust solutions
- ❖ Many companies share responsibility for implementing system:
  - Legal counsel/compliance officer (45%); Secretary (26%); Internal Audit Committee (24%); CFO (22%); Investor relations (18%)
- ❖ Many companies have multiple reporting methods
  - 800 tel. # (74%); email (39%); Internet form (16%); Intranet form (8%)
- ❖ 43% provide training programs; 30% don't or don't plan to; 27% don't know

# Implementing Whistleblower Pipelines

## ▪ **Deloitte April 2003 survey of Fortune 1000 Cos.**

### ❖ Receiving and validating complaints

- General counsel (62%)
- Internal auditor (29%)
- Governance/compliance officer (24%)
- Corporate secretary (5%)
- Risk officer (2%)
- Others (third party, director) (10%)

### ❖ Investigating complaints

- General counsel (69%)
- Internal auditor (51%)
- Risk officer (7%)
- Corporate secretary (3%)
- Others (17%)

## ▪ **Good practice to keep general counsel and CFO apprised and report to audit committee in appropriate circumstances**

- ❖ 60% report as needed; 18% quarterly; 7% annually; 15% undecided

# Implementing Whistleblower Pipelines

- **A May 2005 online survey conducted by National Post/COMPAS (in conjunction with the Canadian Chamber of Commerce) found that 64% of participants said third party solutions were the most effective in persuading employees to report**
  - ❖ About 1/3 of respondents felt that internal reporting systems were “a lot less effective”
- **Institute of Internal Auditors Ethics Hotline Survey Dec. 2003**
  - ❖ 84% U.S. cos and 3.5% Cdn.
  - ❖ 69% had hotlines, 11% in the course of implementing
  - ❖ Strong support for outside providers as better protection against allegations of retaliation, better time zone support, archiving, etc.
  - ❖ Investigation by compliance (43%), corporate legal (57%), internal audit (89%), HR (31%), other (45%)

# Implementing Whistleblower Pipelines

- **Create an Open-Door Policy for reports of fraud**
- **Establish a complaint and investigation protocol**
- **Create an Ethics and Conflict-of-Interest Policy**
- **Publicize Policy Prohibiting Retaliation**
- **Create or Amend Document Retention Policy**
- **Train employees and executives about complaint procedures and company's anti-retaliation commitment (like sexual harassment training)**
- **Monitor compliance**
- **Check insurance coverage**
- **Consider complaint notification system outsourcers**
- **Amend employment practices (be fair on exit and prohibit retaliation – Hell hath no fury like an employee scorned) and NDA's (whistleblowing exception)**

# CODES OF ETHICS



**"Listen, I've got to go. Give my love to everyone  
in Australia."**



**"Browning, for a guy who's worked here 12 years, you're setting a lousy example."**

# Janus Capital Group Case Study

- **Former managers of various funds brought in the hedge fund client that became the group's largest investor (US\$236 million invested – market-timed seven funds)**
  - ❖ When one manager left in 2003 he was praised as “an important contributor” to the firm’s culture by then CEO
  - ❖ Fund-manager pay was partly pegged to asset growth
    - New CIO has vowed to make fund returns a bigger driver of pay than fund-asset growth
- **Much of Janus’ top management, including the former CEO, knew about arrangements allowing improper trading (market timing)**
  - ❖ CEO commissioned an internal review of market-timing in fall of 2002 – subsequent report recommended cessation of practice and circulated to more than 30 staffers, yet Janus continued to enter into market timing arrangements until July 2003
- **August 2004 settlement agreement with SEC finalized April preliminary agreement with SEC and attorneys general of New York and Colorado**
  - ❖ US\$226 million to settle civil fraud charges
- **Several large institutional and individual investors removed assets from Janus management**
  - ❖ E.g. announcement from ING Financial Services (US\$5 billion withdrawal) representing 3.7% of total Janus group assets under management

# The Importance of Corporate Culture

- **Recent study by Waterstone Human Capital and *Canadian Business Magazine* profiled in Oct. 10-23, 2005 issue**
  - ❖ Culmination of six months of interviews with senior execs at 107 companies
    - 82% believe there is a direct connection between culture and financial performance (20% consider it the #1 driver) and this is supported by academic research
    - Yet 72% said their own organization's culture is not the one for the future
    - Acknowledged difficulty of shaping collective behaviour of thousands of employees
  - ❖ Need to implement practical tools to deal with ambiguous concepts of “values, mission, integrity, respect, community, diversity, service”
  - ❖ Not just written code, but also: manner of communication, what achievements rewarded and in what way, how accountability is demonstrated, what kinds of people are promoted and hired, who gets fired (and how) and how people work together
    - Soft issues often get left behind in midst of rapid structural change of businesses over last 20 years due to globalization
  - ❖ Strong cultures are adaptive – they facilitate adoption of strategies and practices that continuously adapted to market and competitive conditions
    - Survey showed only 36% felt they had adaptive cultures
    - 55% with top-down managerial arrogance, fear of risk-taking, inward focus, bureaucracy
    - May become watered down with growth – “misalignment” of employee views and management goals

# Codes of Ethics - Background

- **“The Cheating Culture”** (David Callahan, Harcourt 2004) & the 20/60/20 rule
  - ❖ Spitzer v. Insurance industry and Broker-Dealer industry
- **CIBC Wood Gundy governance review and change of management re investment banking conflicts**
  - ❖ Part of a \$50 million sweeping governance program and settlement with SEC re Enron; includes a pledge to provide mandatory risk training to 37,000 employees and an ethics hotline
  - ❖ Fitch rating review
  - ❖ Recent release of Code of Conduct Guidelines for service providers
- ***In re Caremark International, Inc.* (Delaware Chancery Court 1996) suggests that failure to have a code of ethics and failure to monitor organization’s activities (even where no suspicion) may be a breach of fiduciary duty for the Board**
  - ❖ Derivative lawsuit re kickbacks to healthcare providers
- **Emerging systemic search for ethics risk for Internal Control**
  - ❖ TSE 1995 corporate governance guidelines identified risk management as a Board function
  - ❖ Lots more guidance today: AICPA, CICA, IIA, COSO, Turnbull Guidance for UK Combined Code
  - ❖ ERM goes well beyond financial reporting

# Difficulty of Fixing a Toxic Culture

- **Incoming CEO of Symbol Technologies (2003) after June 2004 Justice Dept. indictments of eight former executives and US\$37 million SEC fine:**
  - ❖ *“There was a toxic subculture that had to be dealt with”.*
- **Marsh & McLennan accused in the press of:**
  - ❖ Bid rigging; tied selling; contingent commissions; related party transactions; conflicts in negotiating settlements; market dominance; Board cronyism and management dominance; tolerance of Putnam Funds market timing practices
  - ❖ Incentive compensation tied to non-competition agts. and “speak wells”
  - ❖ Questionable revenues exceed half of current profits - Business model needs revamp
  - ❖ No tolerance for failing to meet numbers
  - ❖ See: *“The Secret World of Marsh Mac”*, BusinessWeek, November 1, 2004
- **Merck alleged to have used intimidation to silence academic researchers**
- **Citigroup’s loss of Japanese private banking license (2004)**
  - ❖ Series of separate regulatory penalties dating to 2001
  - ❖ Senior management repeatedly assured that problems being rectified but compliance and control reforms promised to regulators not implemented and missed by internal auditors
  - ❖ New Chairman Chuck Prince: *“I never thought that you had to say to people, ‘We want you to grow aggressively – and don’t forget not to break the law’”, Fortune November 29, 2004*
- **New Tyco CEO replaced entire Board and 290 of the 300 highest executives and reformed compensation culture**

Brian Ludmer, Nov. 2005

# Difficulty of Fixing a Toxic Culture

- **See “*Computer Associates Clearing a Cloud*”, BusinessWeek, Nov. 21, 2005, p. 70**
  - ❖ Clean house – every tainted executive and board member must go
  - ❖ Set the ethics bar high – publish clear rules; set up an anonymous WB infrastructure
  - ❖ Find the bottom – conduct a forensic investigation of accounting and culture to find out the true state of the business
  - ❖ Preach patience – set expectations with investors, customers and employees, so you can pursue a long-term strategy
  - ❖ Communicate – constantly update employees, customers and investors – project total transparency
- **See “*Citigroup ‘Dr. Evil’ Bond Trade To Serve as M.B.A. Case Study*”, The Wall Street Journal, Nov. 11, 2005, p.B3**
- **U.S. White House began mandatory hour-long briefings for 3,000 staff on ethics and handling classified information in response to indictment of a top official in “Leakgate” investigation**

# Former SEC Chairman Donaldson

- **November 2004 speech to the Securities Industry Association calls on everyone working in US financial services industry to “re-examine how they do business” to prevent future regulatory abuses**
  - ❖ “The Pandora’s box of abuses in the securities industry” opened in the past couple of years underlined the need for a new commitment to ethical business practices
  - ❖ “Companies and managers and employees from top to bottom must embrace a spirit of integrity that goes well beyond simple adherence to the letter of the law”
  - ❖ SEC to work more closely with the industry to prevent occurrences, not just to prosecute misconduct

# Codes of Ethics

- **Foreign Corrupt Practices Act (1977)**
  - ❖ SEC Release 44969 re compliance programs
    - Program and training is a factor in enforcement
- **The SEC in October 2004 has approved a new NASD rule that requires the CEO of a broker-dealer to make an annual certification regarding his or her firm's compliance systems. The CEO must certify, among other things, that the firm has in place processes to establish, maintain, and review policies and procedures that are reasonably designed to achieve compliance with the federal securities laws and certain SRO rules. The rule also requires each broker-dealer to designate a chief compliance officer and that the CEO and CCO meet at least annually to discuss the certification and compliance efforts.**

# CODES OF ETHICS

- **SEC recently adopted final rules (34-47235) mandated by S-OX s. 406**
  - ❖ Effective for annual reports for fiscal years ending on or after July 15, 2003
  - ❖ Thereafter must must comply with the requirements regarding disclosure of amendments to, and waivers from, their ethics codes
  - ❖ Requires reporting issuers to disclose in their annual report (Form 10-K, 20-F or 40-F) whether they have adopted a written code of ethics that applies to their CEO, CFO, principal accounting officer or controller or people performing those functions
  - ❖ Many have separate codes for different levels of management
  - ❖ If no CofE complying with the SEC regn, must state why

# Codes of Ethics

- **SEC believes that content should vary among issuers**
  - ❖ Specific provisions, compliance procedures and disciplinary measures can be customized
- **However, in order to meet SEC's requisite standard, CofE must be reasonably designed to deter wrongdoing and promote:**
  - ❖ Honest and ethical conduct, including avoidance of conflicts of interest
  - ❖ Full, fair, accurate, timely and understandable disclosure in all public communications
  - ❖ Compliance with law
  - ❖ Prompt internal reporting of code violations to designated person
  - ❖ Accountability for adherence

# Codes of Ethics

- **Code to be made Public:**

- ❖ Exhibit to annual report plus Posting on Website
- ❖ Undertaking to provide for free in annual report

- **Drafting of Code:**

- ❖ Amend Code as issues arise internally or externally
- ❖ Topics: see others' plus portal sites

- **US issuers required to disclose significant changes to, or material waivers of, Code of Ethics on Form 8-K within 5 business days**

- ❖ Alternative procedure for website disclosure
- ❖ Foreign private issuers file annually

- **NYSE and NASDAQ corporate governance rules require codes of ethics for all employees and directors and that they be published on website with corp. gov. guidelines and committee charters**

- ❖ NYSE specifies required content; NASDAQ adopts SEC rule
- ❖ NASDAQ requires waivers to be approved by Bd/Committee and both require prompt disclosure if re Dir. or Ex. Officers

# Canadian Codes of Ethics Rules

- **National Policy 58-201 “Effective Corporate Governance” has a recommended best practice for a Code of Business Conduct and Ethics:**
  - “3.4 The board should adopt a written mandate in which it explicitly acknowledges responsibility for the stewardship of the issuer, including responsibility for:  
(a) to the extent feasible, satisfying itself as to the integrity of the chief executive officer (the CEO) and other executive officers and that the CEO and other executive officers create a culture of integrity throughout the organization;”
  - “3.8. The board should adopt a written code of business conduct and ethics (a Code). The Code should be applicable to directors, officers and employees of the issuer. The Code should constitute written standards that are reasonably designed to promote integrity and to deter wrongdoing ... [and] address the following issues: (a) conflicts of interest, including transactions and agreements in respect of which a director or executive officer has a material interest; (b) protection and proper use of corporate assets and opportunities; (c) confidentiality of corporate information; (d) fair dealing with the issuer's security holders, customers, suppliers, competitors and employees; (e) compliance with laws, rules and regulations; and (f) reporting of any illegal or unethical behaviour”.
  - “3.9. The board should be responsible for monitoring compliance with the Code. Any waivers from the Code that are granted for the benefit of the issuer's directors or executive officers should be granted by the board (or a board committee) only.”
    - ❖ Waivers may be a reportable “material change”

## **National Instrument 58-101 “*Disclosure of Corporate Governance Practices*”:**

**“2.3 Filing of Code – If an issuer has adopted or amended a written code, the issuer must file a copy of the code or amendment on SEDAR no later than the date on which the issuer’s next financial statements must be filed, unless a copy of the code or amendment has been previously filed”**

**- Unclear whether WB policies to be filed; SEDAR filer categories to be amended 2006 to pick up Codes of Ethics, Amendments and WB policies**

### **■ “Form 58-101F1 – Corporate Governance Disclosure**

#### **❖ S.5 Ethical Business Conduct –**

- (a) Disclose whether or not the board has adopted a written code for its directors, officers and employees. If the board has adopted a written code:
  - (i) disclose how an interested party may obtain a copy of the written code
  - (ii) describe how the board monitors compliance with its code, or if the board does not monitor compliance, explain whether and how the board ensures compliance with its code; and
  - (iii) provide a cross-reference to any material change report(s) filed within the preceding 12 months that pertains to any conduct of a director or executive officer that constitutes a departure from the code.
- (b) Describe any steps the board takes to ensure directors exercise independent judgment in considering transactions and agreements in respect of which a director or executive officer has a material interest.
- (c) Describe any other steps the board takes to encourage and promote a culture of ethical business conduct”.

# Code of Ethics Checklist (PricewaterhouseCoopers)

- **Comprehensive:**

- ❖ Conflicts of interest, illegal and improper payments, anti-competition guidelines, insider trading
- ❖ Employees, directors, anyone with significant influence over relationships and dealings with third parties (suppliers, customers, insurers, creditors, competitors)
- ❖ Articulates what constitutes prohibited behaviour, how accountability for code is established and sanctions for non-compliance

- **Waiver approval guidelines vary by seniority**

- **Periodically acknowledged by key employees in a manner which indicates understanding of what to do if they encounter improper behaviour**

- **Accessible to employees and third parties**

- **Appropriateness, consistency, dissemination and reporting of remedial actions**

# Ethics Toolkit

- **Tone at the Top**
  - ❖ Background checks on executive CV's
  - ❖ Compensation vs. peer group companies
  - ❖ Nepotism
  - ❖ Related Party transactions
  - ❖ Stock tickers on computer screens?
  - ❖ Strong governance?
- **Company reputation**
  - ❖ Awards; press clippings; message boards; protests; shareholder proposals; complaints to government; IR intelligence; whistleblowing stats
- **Types and tenor of corporate policies**
  - ❖ Posted prominently
  - ❖ Updated regularly
  - ❖ Employee education, reminders and access and impressions
  - ❖ Discussion of ethics at Board meetings?
- **Openness during interviews – ethics audit**
  - ❖ Are you aware of ethics violations?
  - ❖ How are ethical problems dealt with when they arise?
  - ❖ Are there questionable practices, such as advertising, hiring or billing?
  - ❖ Does the company treat employees fairly?
- **Compensation arrangements tied to corporate culture and policies**
  - ❖ Customer feedback
  - ❖ Realistic goals/targets?
  - ❖ Reinforce ethical practices?
  - ❖ Anticipates problems vs. creates conflicts

# Having a Code of Ethics Isn't Sufficient

## ▪ Need a comprehensive ethics risk culture

- ❖ Prevention, discovery, remediation
- ❖ Assign responsibility, develop processes, board oversight
- ❖ Conform compensation policies and performance review criteria
- ❖ Ethics hotlines, ombudsman offices
- ❖ Ethics training and committees and hiring practices
  - *"Debate Rages Over How to Teach Ethics"*, National Post, March 8, 2004, SR1
  - *"Filling an Ethical Void"*, Toronto Star, Sept. 23, 2004, K1 re MBA training
  - *"Screening for Ethics: How One School Does It"*, NYTimes.com, Nov. 20, 2005
- ❖ Reputation Risk assessment and management

## ▪ Must test the control – Ethics Assessments and Coaching

- ❖ Entity-Level internal controls are the hardest to design controls for, assess, test and change, SO START THERE
- ❖ Cultural assessment, psychometric tools, behavioural economics
- ❖ Interviews and focus groups; self-assessment questionnaires
- ❖ Must get annual sign-off from employees and refresher training
- ❖ See Open Compliance and Ethics Group ([www.oceg.org](http://www.oceg.org)) Framework (May 2004) and "20 Questions" self-assessment guide
  - Provides a framework for integrating governance, compliance, risk management and integrity into the tangible practice of everyday business
- ❖ See Trust Leadership & Growth LLC - [www.tlglc.com](http://www.tlglc.com)

Brian Ludmer, Nov. 2005

# Entity-Level Controls

- **Complete documentation of entity-level controls is just as important as consistent robust documentation for transactional or process controls**
- **Documentation of test plans and test results is also critical to ensure that to the extent possible tests are reperformable**
- **Each COSO component should be tested at the entity-level, which is hard to do (monitoring, information and communication, control activities, risk assessment, control environment)**
  - ❖ COSO doesn't get granular re "behaviour"
    - Look at whether processes foster the right behaviour and risk management
  - ❖ Inquiry is not sufficient
    - Corroborative "structured" inquiry supported by examination, observation and reperformance may be OK
  - ❖ Controls on which other significant controls depend should be tested more extensively
  - ❖ Documentation of testing is as important as for process controls
  - ❖ Roll-forward of testing is also important if testing completed well prior to year-end
  - ❖ Hard to quantify/classify entity-level deficiencies

# Must Monitor and Nurture Corporate Culture

- **Recent study by Waterstone Human Capital and *Canadian Business Magazine* profiled in Oct. 10-23, 2005 issue found that 62% of companies don't monitor the state of their corporate culture**
  - ❖ Ceridian Canada 2004 “culture project” triggered by reorganization of US parent’s business model led to anonymous survey of 1400 employees re what values mattered to them and gaps in the workplace
    - Explored alignment between employees’ perception of culture and the values of the leaders in the organization
  - ❖ See “*The Mood at Homeland Security? Bleak, a Study Says*”, NY Times Oct. 16, 2005, p.17 – only 3% felt personnel decisions based on merit; fewer than 18% felt strongly that accountability for results; just 4% were sure that creativity and innovation were rewarded
- **What leaders say and do sets the tone for the entire organization**
  - ❖ Consistently and clearly communicate important values
  - ❖ Corporate values must accurately reflect the priorities of an organization and be compatible with its strategic mission
- **Nurture the culture**
  - ❖ Must reward/recognize behaviours, not just performance
- **Must hire for cultural fit**
  - ❖ Training for skill is easier than teaching values and leaders at all levels need to be consistent; Hire smart: dig deep; check thoroughly; check multiple internal reviews; hire for value, not “cost”

Brian Ludmer, Nov. 2005

## Having a Code of Ethics Isn't Sufficient - Judgment Required

- **Dec. 2003 Boeing CEO forced to resign amid procurement recruitment scandal (CFO fired as a result of attempted cover-up), following earlier ethical breaches (acquisition of Lockheed Martin documents – gov't stripped Boeing of US\$1 billion of rocket launch business) and poor corporate performance**
  - *"U.S. Intensifies Probe of Boeing Hire"*, Wall Street Journal August 27, 2004
  - Special Report on recommended practices from former US Senator Warren Rudman and created an Office of Internal Governance (central watchdog group responsible for ethics, internal audit, import-export compliance, supervision of hiring of foreign sales consultants and other closely regulated matters)
- **Johnson & Johnson**
  - Set ethical standard in Tylenol recall of 1982
  - Dec. 2000 pleads guilty to misdemeanor criminal charges and pays fines of \$60 million for selling defective glucose monitors and submitting false information about problems to FDA
    - Mgt. team felt it was best device on market and that problems weren't serious enough to report - Probably correct, but bad judgment
- **Marriott International involved in multiple litigation related to hotel management contracts**
  - Allegations of unaccounted for purchasing rebates, conflicts regarding services provided by related entities, allocation of corporate overhead, allowing affiliated chains to encroach on clients' trade areas

# Hiring Practices

- **Ethical value system often set even before graduate school**
- **Use of multiple interviews and psychological testing**
- **Look for people who say:**
  - ❖ “There are certain things that we are not going to do. We are going to play hard but respect the law. We will not mislead. We will be transparent. When operating in an environment in which corruption prevails, we will be very firm about what we believe in. We will make sure that we don’t fall into the trap of saying: “Everyone else is doing it. I have to do it too”.

# Must test the control – Ethics Assessments and Coaching

- **20 Questions to Ask About Your Codes of Ethics**  
(Ethikos journal, July/August 2003)
  - ❖ Should there be separate codes for different players?
    - Board, senior management, operational employees
  - ❖ Does the Code cover newly developing risks?
  - ❖ For what you already cover, have you kept up with developments in the law?
  - ❖ What do you tell employees about raising questions?
  - ❖ Do employees certify the Code annually?
  - ❖ Does the Code include examples?
  - ❖ Is the format inviting and effective?
  - ❖ What does the Code say about values?
  - ❖ Is the Code's organization useful?
  - ❖ Are there "finding aids" in the Code?
  - ❖ Does the Code lead to other information sources?
  - ❖ Did the Code get the benefit of input from key constituencies?
  - ❖ Is there a communications plan in place for use after the Code is issued [or breached]?
  - ❖ Has the Code entered the electronic age?
  - ❖ Does the Code's message reach third parties?
  - ❖ Is the Code global?
  - ❖ Is the Code translated?
  - ❖ Does the Code include things that no longer make sense?
  - ❖ Does the Code go to all employees?
  - ❖ Is the Code ethical and legal?

Brian Ludmer, Nov. 2005

## Learn from open standards, best practices, and the experiences of others

- The Ethics Resource Center (ERC). A 75-year old non-profit organization based in Washington, D.C., and dedicated to the promotion of ethical behaviour globally [www.ethics.org](http://www.ethics.org)
- The Open Compliance & Ethics Group (OCEG). A non-profit organization based in Washington, D.C. that is dedicated to the research and publication of best practices in compliance education and supporting processes [www.oceg.org](http://www.oceg.org)
- The Corporate Compliance Institute. A series of annual educational and networking conferences held by the Practising Law Institute (PLI) at various venues throughout the United States [www.pli.edu](http://www.pli.edu)

## Learn from open standards, best practices, and the experiences of others (2)

- **The Markkula Centre for Applied Ethics at Santa Clara University**  
[[www.scu.edu/ethics](http://www.scu.edu/ethics)]
- **Business Ethics.ca** [[www.businessethics.ca](http://www.businessethics.ca)]
- **The Aspen Institute** [[www.caseplace.org](http://www.caseplace.org)]
- **Institute for Global Ethics “Ethics Newslines”**  
[[www.globalethics.org/newsline/members/index.tmpl](http://www.globalethics.org/newsline/members/index.tmpl)]
- **The Ethics Education Resource Centre of AACSB International**
- **SOX-Online: The Vendore-Neutral Sarbanes-Oxley Site**  
[[www.sox-online.com/index.html](http://www.sox-online.com/index.html)]
- **Journals: Business & Society; Business Ethics Quarterly; The Journal of Business Ethics; Business Ethics**
- **See book “*Winning legally*”, published 2005, Harvard Prof. Constance Bagley**
- **See book “*Business & Professional Ethics for Directors, Executives & Accountants, 3<sup>rd</sup> edition*”, Leonard J. Brooks, Thompson 2004**

## **Learn From Open Standards, Best Practices, and the Experiences of Others (3)**

- **Leading peer review journals include:**
  - ❖ Journal of Business Ethics (Kluwer)
  - ❖ Electronic Journal of Business Ethics and Organizational Studies
- **Recent study by Prof. Mark Schwartz of York University re effectiveness of Codes of Ethics**
  - ❖ Fairness of provisions
  - ❖ Use of concrete examples
  - ❖ Negative tone more effective
  - ❖ Training matters
  - ❖ Big debate about whether obligation to report will be followed
  - ❖ Support from senior management essential

# 2002: The Year of the Whistleblower

- ❖ Roy L. Olofson of Global Crossing
- ❖ Joe Speaker of Rite Aid
- ❖ Sherron Watkins of Enron
- ❖ Cynthia Cooper of WorldCom
- ❖ Ted Beatty of Dynegy
- ❖ Coleen Rowley of the FBI
- ❖ David McNally of Ahold
- ❖ Countless others (e.g.. HealthSouth)
  - Middle management always knows and is targeted by regulators

# **ENTITY-LEVEL CONTROLS WHISTLEBLOWING SYSTEMS AND CODES OF ETHICS**

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