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## Shaping Your Whistleblower System

*The concept is simple, but new rules make it more complex.*

by Gerald D. Bloch

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The governance elements of the federal Sarbanes-Oxley law have been well discussed, but actual implementation is proving a challenge. One such challenge is the demand for employee “whistleblower” programs which bring employee concerns over possible irregularities to the attention of the board. How are subsequent SEC and stock exchange rules complicating this law? What role should your board play in the process?

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The whistleblower complaint process required under the Sarbanes-Oxley Act of 2002 has been overshadowed by some of the more noteworthy reforms of the legislation. Because it can provide the audit committee with an uncensored view of what is happening under the top layer of a company’s management, however, the complaint process is a powerful instrument in its own right. Audit committee members should take full advantage of it.

Some companies have always sought the input of their employees. From old-fashioned suggestion boxes to hotlines, ombudsmen and open-door policies, processes have evolved to facilitate communications within the corporation. Old communication tools and processes for handling employee complaints should be reconsidered in light of the Act’s requirements. New processes must be developed or existing ones upgraded.

The Act lays out several specific whistleblower requirements:

*Role of audit committee.* The audit committee is required to “establish procedures.” The committee is not explicitly required to oversee the process once it is established, and it remains unclear whether the audit committee has continuing responsibility for the process.

*Matters covered.* The process must handle “accounting, internal accounting controls, or auditing matters.”

*Who can complain.* The process must deal with

any complaint “received by the issuer.” It does not limit those who may complain. The process must be open to employees, investors, analysts, stock exchange officials and anyone else.

*Confidentiality and anonymity.* The process must provide confidentiality and anonymity to employees. However, at least one rule-making organization has suggested that this may be applied to nonemployees as well.

*Function of process.* The process must cover the “receipt, retention, and treatment of complaints.” This makes clear that the process cannot be limited just to the intake of complaints. It must include a records retention function and some action taken following the complaint, such as an investigation.

**Your whistleblower process should be viewed as an opportunity to strengthen the board as an independent counterweight to management.**

The broad thrust of Sarbanes-Oxley and its related regulatory guidelines is to promote the independence of the board of directors and to increase the power and responsibilities of the board’s audit committee. As stated in The Conference Board Commission on Public Trust and Private Enterprise *Findings and Recommendations on Corporate Governance*, “the objective is to strengthen the independence and role of the board with appropriate checks and balances on the power, actions and performance of the CEO.”

Your whistleblower complaint process should be viewed as an opportunity to strengthen the board of directors as a counterweight to company management.

Compliance with the minimum requirements of the Act and enhancing the board’s independence are

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guiding principles. However, a functional and robust complaint process must have other features:

*Prevention of misconduct.* Legal requirements are too often viewed only as items on a checklist. The company and its audit committee should instead view the complaint process as an opportunity to prevent or mitigate the effect of misconduct and the resulting liability, as well as to enhance the company's reputation and boost public trust in its business. The object should be to ferret out claims before they become serious, allowing for early and low cost resolutions.

*Audit committee oversight.* The audit committee must do more than "establish" the process. Committee members must oversee its operation as well. The process should be kept out of the hands of management to circumvent a potentially unresponsive or resistant bureaucracy. This strengthens the check and balance role of the board by providing it with an early warning of potential problems. It will also encourage complainants to come forward and ease the fear that complaints will be suppressed or the complainant will be retaliated against.

The SEC endorses such a role for the audit committee:

"Since the audit committee is dependent to a degree on the information provided to it by management and internal and outside auditors, it is imperative for the committee to cultivate open and effective channels of information. Management may not have the appropriate incentives to self-report all questionable practices. A company employee or other individual may be reticent to report concerns regarding questionable accounting or other matters for fear of management reprisal. The establishment of formal procedures for receiving and handling complaints could serve to facilitate disclosures, encourage proper individual conduct and alert the audit committee to potential problems before they have serious consequences."

This is clearly a mandate for audit committee oversight and control of the complaint process.

*Limit burdens on audit committee members.* Sarbanes-Oxley has greatly increased the role of the

audit committee by giving it greater responsibilities. However, its members meet infrequently and cannot devote their full time and attention to company business. So it is imperative that their oversight role not overburden them.

*Process functionality.* The process must be capable of handling the "receipt, retention, and treatment of complaints," as stated in the Act. All functions should be systematized into a set of routines carried out as uniformly as practicable for each aspect of the process. The potential for complaints to "fall through the cracks" should be eliminated.

**The complaint process must be credible, instilling confidence that anonymity and confidentiality are assured. One way to accomplish this is through an independent third party.**

The first element here is *intake*, the "*receipt*" function. Many employees distrust internal corporate communication processes, believing that they protect management rather than complainants or are a facade having little substance. They will be inclined to believe that management will learn their names and the substance of their complaints, risking retaliation.

To counter these beliefs, the complaint process must be credible. It must instill confidence that complaints will be properly handled, without the risk of subversion by management. Anonymity and confidentiality must be assured. Also, the intake process must be readily available and easy to use. One way to accomplish this is to place the process in the hands of an independent third party to ensure that complaints will bypass the management structure.

A second element of the process is the *recording of complaints*, the "*retention*" function. Complaints must be retained, along with a record of the prescribed follow-up activities. The medium for retaining this information should provide ready access to authorized persons. Storage by electronic means with a third party is preferable to prevent loss of documents through human error or intentional destruction.

Finally, any whistleblower process must address *complaint follow-up*, the “*treatment*” function. The cornerstone of any process is how well it handles complaints after receipt.

*Complaint handling role—“The Investigator.”* The integrity of this process will largely be judged on how the complaint is investigated and resolved. Thus, the selection of the person responsible for the investigation is of critical importance. Audit committee members themselves should not conduct the investigation unless they have both the time and necessary training or experience. Other options include in-house legal counsel, outside legal counsel, human resource personnel, internal audit staff, outside auditors or the company’s ethics or compliance officer.

The SEC Proposed Rule offers this guidance:

“The assistance of outside advisors also may be needed to independently investigate questions that may arise regarding financial reporting and compliance with the securities laws. Accordingly, the proposed rule would specifically require an issuer’s audit committee to have the authority to engage outside advisors, including counsel, as it determines necessary to carry out its duties.”

The Conference Board Commission Report takes this a step further. As a “best practice” suggestion, it also proposes that:

“Special counsel retained to conduct independent investigations with likelihood to implicate company executives should report directly to the board or an appropriate committee of the board and should not be an individual or a firm that the company regularly uses as outside counsel or that derives a material amount of revenues from the company.”

Further, the Act gives the audit committee the power to pay for outside counsel it chooses to retain. Independent counsel offers a further source of information for the audit committee separate from that provided by the company’s management. Counsel can be used to “drill down” into the organization to tap into hidden reservoirs of facts, which can be used to question or confront management. Further, out-

## **Follow-Up On Complaints**

### **The “Treatment” Function**

After receipt and recording of a whistleblower complaint, the next step is complaint follow-up. This “treatment” function can be broken down into several steps for an overall “investigation”:

- Communication.* The process should allow participants to communicate with one another. For instance, the process should provide a confirmation to the complainant that the complaint has been received, and allow the person assigned to handle the complaint and members of the audit committee to communicate with each other.
- Evaluation.* An initial evaluation of the complaint must determine its seriousness and priority so that decisions concerning the resources to be devoted to it can be made.
- Investigation.* An investigation should determine the facts related to the complaint to determine whether any misconduct, violation of law, breach of ethics or company policy has occurred.
- Report.* The person responsible for investigating the complaint should prepare a report describing the complaint, the facts learned in the investigation and conclusions as to whether they constitute misconduct, violations of law, breaches of ethics or company policy, etc.
- Corrective action.* Following the report, a determination must be made as to what action, if any, should be taken. This would include disciplining those involved, correcting the processes or conditions which led to the misconduct, and reporting the misconduct to regulatory authorities, if required.

side counsel is better positioned to maintain confidentiality and anonymity, which will reduce the risk of retaliation against complainants.

**Cost is an issue in any whistleblower process. Outside counsel can act as a gatekeeper, investigating the more serious allegations, while referring others to less expensive options.**

One issue in making independent counsel the point person for your whistleblower complaints is cost. Any complaint process produces a number of insubstantial or frivolous allegations in subject areas

beyond those covered by the Act, for which the company may have other processes. An outside counsel investigation of such complaints would be expensive and unnecessary.

To control costs, outside counsel should act as a “gatekeeper.” Counsel evaluates all complaints, investigates those involving the more serious allegations such as misconduct by company executives and refers all others to the appropriate department or employee within the company. This may be human resources, legal, internal auditing or the company’s ethics or compliance officer.

*Security.* The information that flows through the process must remain strictly confidential. The Act requires confidentiality but beyond that, should complaint information find its way into the wrong hands, the company could face litigation-related costs and losses and adverse publicity.

### **The Conference Board and Nasdaq rules encourage integrating your whistleblower process into the corporation’s code of ethics.**

Sarbanes-Oxley requires each company to disclose whether it has adopted a “code of ethics” for senior financial officers. A proposed Nasdaq rule change further requires companies to adopt a code of ethics for all “directors, officers and employees.” It also states that, “Each code of conduct must contain an enforcement mechanism that ensures prompt and consistent enforcement of the code, protection for persons reporting questionable behavior, clear and objective standards for compliance and a fair process by which to determine violations.

The Conference Board Commission goes further. Among its “best practice” suggestions are:

- Programs to ensure that employees understand, apply, and adhere to the company’s code of ethics.
- Processes that encourage and make it safe for employees to raise ethical issues and report possible ethical violations.
- Processes for prompt investigation and disposition of complaints, including discipline and corrective action, if necessary.

Designation of a board committee to oversee ethics issues.

Designation of an officer to oversee ethics and compliance with the code of conduct.

Disclosure of practices and processes the company has adopted to promote ethical behavior.

The Nasdaq rule change mandates a code of ethics with attributes similar to the whistleblower complaint process required under the Act. The Conference Board Commission’s best practice suggestions for handling ethical issues are equally applicable to the whistleblower complaint process. There is little distinction between the two.

The implication is that the whistleblower complaint process be fused into the code of ethics. This demands that the latter handle a wider range of matters than is strictly required under the Act. The efficiency of a unified policy and process for handling complaints under the Act and the broader matters arising under a code of ethics should be clear.

The company’s integrated ethics code/complaint process should cover such topics as:

- The conduct the company seeks to promote, as well as prohibited conduct.
- The types of complaints to be made under the process.
- How the complaint process works, including who investigates complaints, how the investigation will be conducted and corrective action determined.
- Confidentiality, anonymity and retaliation.
- Instructions as to how to make a complaint.

The integrated code of ethics/complaint process must be broadly disseminated to be effective. A company is only *required* to provide a copy of its code of ethics with its annual report. However, it should also be posted in the employee handbook or manual (both hard copy and intranet or web versions). The investor relations and corporate governance pages of the company’s website and other company publications dealing with legal compliance or conflicts of interest should also include the code of ethics.

Companies should consider training employees on its code of ethics and complaint process. This

underscores its commitment to abiding to the highest standard of conduct and reducing breaches. To keep costs reasonable, training can be limited to those employees most likely to be exposed to potential misconduct.

A web-based complaint handling process can fully integrate all of the features described above in a neat and easy to use format. There are other alternatives, however. Employee “help lines” or phones operated by the company or third parties have long been used. Ombudsmen, ethics officers, compliance officers and human resource personnel are also part of the complaint process landscape. However, they are neither as complete nor better meet the requirements of the Act and “best practice” guidance.

These tools still have utility. No *one* process should be offered as the sole answer for handling complaints. A person desiring to make a complaint may simply want to pick up the phone or write a letter. The code of ethics/complaint process should offer alternatives to satisfy these preferences. Also, the investigator in a web process, as gatekeeper, will be referring complaints to these other players, or enlisting their assistance in investigations he or she is conducting.

There may be fears that the whistleblower complaint process is “too good.” That is, it may uncover facts or situations best left hidden, exposing the company, its officers and directors to liability where none may have existed. This is false. Among experienced legal professionals, it is a rule that the sooner one learns of a problem, the easier and less costly it is to resolve. This principle should be foremost in the minds of those involved in designing the whistleblower complaint process. ■

### **Web-Based Complaint Handling** **Use Third Party For Confidentiality**

A web-based complaint handling process can provide a fully-integrated, neat and easy to use format.

The web solution should be hosted by a *third party* to establish it as independent of company management. A company-controlled website *cannot* be safeguarded enough to avoid potential breaches of confidentiality or losses of anonymity. Further, those desiring to complain will not have as high a level of confidence in a process operated by the company.

The code of ethics/complaint process disseminated by the company directs those wishing to make complaints to the website. The complaint initiator completes a form by including the details of the matter. He or she could remain anonymous simply by not providing contact information.

The complaint details are stored in a database wedded to the website. An outside attorney or law firm retained by the audit committee as investigator is notified by email that a complaint has been made. The investigator accesses the information in the database, and then evaluates the complaint and conducts an investigation. All information developed during the investigation is retained in the database as required by the Act.

The investigator and audit committee communicate as necessary via the website, avoiding potential leaks of confidential information. The database preserves a record of those communications. Access to information in the database is limited to those with an access code. The website has firewalls and other security features offering the greatest protection available to deter hackers and unauthorized persons from gaining access.

The web-based complaint process is a self-contained, seamless process for handling all aspects of a complaint from start to finish, from complaint initiation to corrective action to communication of the final outcome to the complaint initiator. It is a complete solution combining the most desirable features for handling whistleblower-type complaints.

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