RECOMMENDATIONS FOR AN EXTERNAL WHISTLEBLOWER PROGRAM AGAINST SECURITIES FRAUD IN THE PHILIPPINES*

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INTRODUCTION

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[1] created an external whistleblower awards program[2] which expanded the internal whistleblower protections for employees previously granted by the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").[3] The U.S. Securities and Exchange Commission ("U.S. SEC"), through its rulemaking power granted under Dodd-Frank,[4] created an Office of the Whistleblower[5] to oversee the Whistleblower Award Program.

These protections were previously limited to employees of public corporations. Dodd-Frank extended them to employees of the public corporations' subsidiaries and affiliates whose financial information is included in the public corporation's consolidated financial statements.[6]

The two largest stock exchanges, the New York Stock Exchange[7] and NASDAQ,[8] likewise have external whistleblowing awards programs.

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[1] Pub. L. 111-203 (2010).

[2] Dodd-Frank § 922, Whistleblower Protection.

[3] 15 U.S.C. 7201 et seq. (2002).

[4] § 922(j).

[5] The U.S. Securities and Exchange Commission, Office of the Whistleblower, *at* http://www.sec.gov/whistleblower (last visited: November 14, 2012 at 1:46 A.M. EDT).

[6] § 929A, Protection For Employees Of Subsidiaries And Affiliates Of Publicly Traded Companies.

[7] NYSE Euronext Code of Ethics and Business Conduct, *available at* http://www.nyse.com/pdfs/nyse_euronext_code_of_ethics_and_business_conduct.pdf (last visited Nov.9, 2012 at 1:53 A.M. EDT).

In the Philippines, there is no similar external whistleblower awards program. In fact, whistleblowing itself is a novel concept in the Philippines, as the Philippines' first whistleblower law is still currently in its second reading in the Philippine Senate.[9] There is a lack of an overall whistleblower infrastructure to support the reporting of corporate and securities fraud. In addition, the Asian culture of group conformity and the Philippine ownership structure of family-dominated holding companies tend to discourage a whistleblowing culture.

Despite its lack of a legal framework as well as a culture of whistleblowing, the Philippines may still benefit from an external whistleblowing program similar to that of the U.S. SEC. This external whistleblowing mechanism may serve as a stopgap measure for the deficiencies in Philippine laws and regulations regarding corporate internal control mechanisms, which do not provide for strong internal whistleblower structures compared to those of the U.S. Ultimately, an external whistleblowing awards program may address the internal control deficiencies of corporations in the Philippines.

In March 2003, after the reorganization of WorldCom, Inc., the formal report of the Special Investigative Committee of its board of directors ("board") stated:

> That the fraud continued as long as it did was due to a lack of courage to blow the whistle on the part of others in WorldCom's financial and accounting departments.[10]

A corporation's internal control system encompasses the corporation's internal audit functions, risk management system, disclosure reporting system, financial reporting mechanisms, compliance with the laws and best practices, and corporate ethics. Ideally, this internal control system should have an internal reporting or whistleblowing mechanism for employees, officers,

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[8] NASDAQ OMX Whistleblower Hotline, *available at* http://www.nasdaqomx.com/services/corporatesolutions/governance/whistleblowerhotline/ (November 9, 2012 at 2:36 A.M. EDT).

[9] S. No. 2860, 15th Cong. (2011). This is the Whistleblower Protection Act of 2011.

[10] Whistleblowing Arrangements: Guidance for Audit Committees, Institute of Chartered Accountants in England and Wales, 2, *available at* /http://www.icaew.com/~/media/Files/Technical/Audit-and-assurance/audit/guidance-for-audit-committees/whistleblowing-arrangements.pdf (last visited Nov. 14, 2012 at 9:45 P.M. EDT).

lawyers, auditors, and management to report fraudulent practices within the corporation. This whistleblowing mechanism also serves as a deterrent against future fraud. However, the act of whistleblowing has several unfavorable consequences for the persons reporting, such as retaliation, which may thus discourage persons from "blowing the whistle" on fraudulent activity within the corporation.

A strong internal whistleblowing system is one that empowers the so-called "gatekeepers:"[11] (1) the auditors, (2) the lawyers, and (3) the employees. However, as much as an internal whistleblowing system can be a safety valve and a deterrent against fraudulent practices, it can still fail for a variety of reasons. For instance, a gatekeeper may hold back information due to the lack of proper anti-retaliation measures. Corruption may also keep the gatekeeper silent. This is where an external whistleblowing awards program such as that of the U.S. SEC can step in to fill in these gaps.[12]

As will be examined in this paper, U.S. corporations already benefit from strong internal control systems brought about by Sarbanes-Oxley and strengthened by Dodd-Frank. The U.S. SEC's whistleblower program[13] further supplements the internal whistleblowing already being accomplished by the U.S. corporate gatekeepers.

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[11] The term "gatekeepers" post-Enron was specifically defined by Professor John Coffee as "reputational intermediaries who provide verification and certification services to investors." Examples of these services and their corresponding "gatekeepers" include verification of a corporation's financial statements by an independent auditor; evaluation of the creditworthiness of the corporation by the debt rating agency; an assessment of a corporation's business and financial prospects compared to its rivals by a securities analyst; or the appraisal of the fairness of a specific transaction by an investment banker. Professor Coffee also considers lawyers as "gatekeepers" when they lend their professional reputations to a transaction, but are more of "transaction engineers" rather than reputational intermediaries. A professional "gatekeeper" essentially assesses or vouches for the corporate client's own statements about itself or a specific transaction. John C. Coffee, *Understanding Enron: It's About the Gatekeepers, Stupid*, COLUMBIA LAW SCHOOL WORKING PAPER SERIES NO. 207, Jul. 30, 2002, at 5, as cited in Jardeleza-Eisenberg paper, *infra* note 87 at 3.

[12] There are various scholarly debates in the United States on whether an external whistleblowing program such as that of the U.S. SEC undermines the internal whistleblowing mechanisms of corporations. These are only briefly discussed in Part IV: Recommendations but is beyond the scope of this paper.

[13] Dodd-Frank, § 922.

In contrast, Philippine laws are deficient in providing for strong internal control mechanisms for corporations. Only one of the three gatekeepers,[14] the auditors, are protected by laws and regulations to perform their "gatekeeping" duties. The two other gatekeepers, the lawyers and the employees, are not empowered to guard the corporate gates against fraud. Thus, it may be beneficial for the Philippines to have a formal external whistleblower protection managed by the regulators in order to close these gatekeeping gaps.

Part I of this paper outlines the current framework of internal controls under Sarbanes-Oxley to the new whistleblower protections under Dodd-Frank. Part II discusses the deficiencies in internal controls in the Philippines compared to the U.S. Part III is a discussion and analysis of the various factors that may affect the implementation of an external whistleblower awards program in the Philippines. Finally, Part IV concludes that the Philippines sorely needs an external whistleblowing awards program due to the insufficiencies of its laws and regulations for a proper internal whistleblowing system as part of a corporation's internal controls.

PART I: THE U.S. INTERNAL CONTROLS SYSTEM

A. General Internal Control Standards Mandated by Sarbanes-Oxley

The United States Congress enacted the Sarbanes-Oxley[15] aimed at sweeping and comprehensive federal corporate governance reforms– from accounting standards, audit committee rules, and disclosure requirements to more extensive regulation of securities analysts and white-collar crime penalty enhancements.

Sarbanes-Oxley mandated the U.S. SEC to prescribe rules that would require a public and/or listed corporation to file an annual report required

[14] This paper is limited to a discussion of the three major "gatekeepers" within the corporation: the auditor, the lawyer, and the employee.

[15] Part 205 – Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 15 U.S.C.A. §§ 7201 et seq., 17 CFR §§ 205 et seq.

under Section 13(a)[16] or Section 15(d)[17] of the Securities Exchange Act of 1934[18] ("Exchange Act"). This annual report is supposed to contain an internal control report. The internal control report shall state the responsibility of management to establish and maintain an adequate internal control structure and procedures for financial reporting.[19] It shall also contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.[20]

An annual report that contains the required internal control report is also known as a Form 10-K.[21] Part II, Item 9A of Form 10-K on Controls and Procedures requires issuers to furnish the information required by Items 307 and 308 of Regulation S-K.[22] Item 307[23] requires issuers of securities to disclose the conclusions of the principal executive and principal financial officers, or persons performing similar functions, regarding the effectiveness of the issuer's disclosure controls and procedures[24] as of the end of the period covered by the report, based on the evaluation of these controls and

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[16] Exchange Act § 13(a) is for issuers of securities who are filing registration statements pursuant to §12.

[17] § 15(d) is for every issuer who has filed a registration statement that contains an undertaking and those who have filed registration statements that have become effective and are required to file supplementary and periodic information, documents and reports as may be required by §13 in respect of a security registered pursuant to § 12.

[18] 15 U.S.C. § 78a et seq. (1934).

[19] 15 U.S.C. 7201 et seq., §404(a)(1).

[20] § 404(a)(2).

[21] Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

[22] Standard Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975, 17 CFR § 229 et seq.

[23] Regulation S-K, Disclosure Controls and Procedures, *supra* note.22.

[24] "Disclosure controls and procedures" are defined as controls or procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the U.S. SEC's rules and forms. These include controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's managements, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. As defined under Rule 13a-15(e) or Rule 15d-15(e) of the Exchange Act.

procedures required by Rule 13a-15(b) or Rule 15d-15 under the Exchange Act.

Item 308,[25] on the other hand, requires registrants to provide a management annual report regarding the issuer's internal control over financial reporting.[26] This management report requires three different statements. First, it requires a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the issuer.[27] The second statement refers to an identification of the management framework used to evaluate the effectiveness of the registrant's internal control over financial reporting.[28] Finally, management should make a third statement of its assessment of the effectiveness of the issuer's internal control over financial reporting as of the end of the issuer's most recent fiscal year. This should be accompanied by a statement as to whether or not internal control over financial reporting is effective.

Management must also disclose any material weaknesses in the registrant's internal control over financial reporting. If there are one or more weaknesses in the issuer's internal control over financial reporting, management should not conclude that the issuer's internal control over financial reporting is effective.[29] Finally, management should disclose any change in the issuer's internal control over the financial reporting identified in

[25] Regulation S-K, Internal Control Over Financial Reporting, *supra* note 22.

[26] "Internal control over financial reporting" is defined as a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board , management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that: (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directions of the issuer; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements. As defined under Rule 13a-15(f) or Rule 15d-15(f) of the Exchange Act.

[27] Regulation S-K, Item 308(a)(1), *supra* note 22.

[28] As required by Rule 13a-15(c) or Rule 15d-15 under the Exchange Act. Regulation S-K, Item 308(a)(2), *supra* note 22.

[29] Regulation S-K, Item 308(a)(3), *supra* note 22.

the evaluation required[30] that occurred in the issuer's last fiscal quarter in the case of an annual report. These are changes that have materially affected, or are reasonably likely to materially affect, the issuer's internal control over financial reporting.[31] In addition to the internal control report required to be submitted within Form 10-K, each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer.[32]

Sarbanes-Oxley likewise requires corporate responsibility for financial reports.[33] Aside from ensuring effective internal controls in disclosures, the principal executive officer(s) and the principal financial officer(s), or persons performing similar functions, must certify in each annual or quarterly[34] report filed or submitted that (i) the signing officer has reviewed the report,[35] (ii) based on the signing officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading,[36] and, (iii) based on the signing officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report.[37]

The signing officers are responsible for establishing and maintaining internal controls.[38] They must design such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared.[39] The signing officers must likewise have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report.[40] They should have

[30] As required by Rule 13a-15(d) or Rule 15d-15 under the Exchange Act.

[31] Regulation S-K, Item 308(c), *supra* note 22.

[32] Sarbanes-Oxley, § 404(b).

[33] § 302, Corporate Responsibility for Financial Reports.

[34] This is also known as Form 8-K (Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934).

[35] Sarbanes-Oxley § 302(a)(1).

[36] § 302(a)(2).

[37] § 302(a)(3).

[38] § 302(a)(4)(A).

[39] § 302(a)(4)(B).

[40] § 302(a)(4)(C).

presented their conclusions in the report about the effectiveness of their internal controls based on their evaluation as of that date.[41]

The signing officers must also have disclosed to the issuer's auditors and the audit committee of the board of the corporation all significant deficiencies in the design or operation of internal controls that could adversely affect the issuer's ability to record, process, summarize, and report financial data.[42] They should have identified any material weakness in internal controls for the issuer's auditors.[43] They are also responsible for reporting any fraud, whether or not material, involving management or other employees who have a significant role in the issuer's internal controls.[44] Finally, the signing officers should indicate in the report whether or not there are significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.[45]

B. Auditing Standards

Sarbanes-Oxley likewise established the Public Company Accounting Oversight Board ("PCAOB") as an external and independent body[46] to oversee the audit of public corporations that are subject to securities laws. The mandate of the PCAOB is to ensure the preparation of informative, accurate, and independent audit reports for corporations the securities of which are sold to, and held by and for, public investors.[47]

The Auditors as Gatekeepers

The PCAOB is mandated to establish standards relating to the preparation of audit reports for issuers.[48] As previously stated, in addition to

[41] § 302(a)(4)(D).
[42] § 302(a)(5)(A).
[43] § 302(a)(5)(A).
[44] § 302(a)(5)(B).
[45] § 302(a)(6).
[46] The accounting profession was previously self-regulating under the American Institute of CPAs or AICPA.
[47] Sarbanes-Oxley, § 101(a), Establishment; Administrative Provisions.
[48] § 101(c)(2).

the internal control report required by Form 10-K, each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer.[49] Auditors likewise audit management's assessment of the effectiveness of internal control over financial reporting that is integrated with an audit of the corporation's financial statements.[50]

The PCAOB states that "effective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes. If one or more material weaknesses exist, the company's internal control over financial reporting cannot be considered effective."[51] The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting. If one or more material weaknesses exists,[52] a corporation's internal controls cannot be considered effective. The auditor must conduct the audit[53] in such a

[49] § 404(b).

[50] Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements, PCAOB Release No. 2007-005A, ¶ 1.

[51] ¶ 2.

[52] Some indicators of material weaknesses in internal control over financial reporting include the identification of fraud, whether or not material, on the part of senior management; the restatement of previously issued financial statements to reflect the correction of a material misstatement; the identification by the auditor of a material misstatement of financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting; and ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee. Auditing Standard No. 5,,¶ 69.

[53] There are thus two audits involved – one for the management assessment of internal control for financial reporting and another for the financial statements. The auditor is supposed to conduct his or her audits simultaneously, bearing in mind the search for separate evidence to prove each audit's material weaknesses separately. Auditing Standard No. 5, ¶¶ 6-7. Some factors that the auditor will need to consider in the course of the audit include, among others, knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor; matters affecting the industry in which the company operates; matters relating to the company's business; the extent of recent changes, if any, in the corporation, its operations, or its internal control over financial reporting; the auditor's preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses; control deficiencies previously communicated to the audit committee or management; legal or regulatory matters of which the corporation is aware; the type and extent of available evidence related

way as to obtain evidence that would provide reasonable assurance that such material weakness or weaknesses exist as of the date specified in management's assessment. These material weaknesses may exist even if the statements are not material misstated.[54]

An auditor is also supposed to perform risk assessment. He or she should determined the significant accounts and disclosures, relevant assertions, the controls for testing, and the determination of the evidence necessary for a given control.[55] Auditors should conduct fraud risk assessment.[56] This is an evaluation of whether the corporation's controls sufficiently address identified risks of material misstatement due to fraud and whether the controls were intended to address the risk of management override other controls.[57]

The evidence necessary for the auditor to conclude that a control is effective depends upon the risk associated with such. It consists of the risk that the control might not be effective and, if found ineffective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.[58]

Once the auditor completes the gathering of evidence, he or she must evaluate the severity of each control deficiency to determine if they, individually or in combination, are material weaknesses as of the date of management's assessment.[59] It depends on whether there is a reasonable

to the effectiveness of the company's internal control over financial reporting; preliminary judgments about the effectiveness of internal control over financial reporting; public information about the corporation relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting; knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and the relative complexity of the company's operations. Auditing Standard No. 5, ¶ 9.

[54] Auditing Standard No. 5, ¶ 3.

[55] ¶ 10.

[56] See also Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement, PCAOB Release 2012-04.

[57] Some examples of these controls include: controls over significant, unusual transactions; controls over journal entries and adjustments made in the period-end financial reporting process; controls over related party transactions; controls related to significant management estimates; and controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results. Auditing Standard No. 5, ¶ 14.

[58] Auditing Standard No. 5, ¶ 46.

[59] ¶ 62.

possibility that the corporation's controls will fail to prevent or detect a misstatement of an account balance or disclosure, and the magnitude of the potential misstatement resulting from the deficiency or deficiencies.[60]

Auditors may perform "walkthroughs" in order to understand and evaluate the design and proper implementation of the controls. For example, the auditor may talk to the appropriate personnel, observe company operations, and inspect relevant documents.[61] The PCAOB standards require auditors to ask "probing questions" in addition to these walkthroughs to understand a corporation's control process and assess if they are present and are being utilized effectively.[62] This inquiry includes coordinating with the audit committee or internal auditors who might reasonably be expected to have information that would identify risks of material misstatement and fraud risks.[63] Persons involved in the walkthrough process, such as operations personnel, personnel who are involved with processing complex or unusual transactions, and in-house counsel should be asked probing questions as well.[64]

After forming an opinion on the effectiveness of internal control over financial reporting by an evaluation of the evidence obtained, the testing of controls, the detection of misstatements, and the identification of control deficiencies,[65] the auditor, under the U.S. SEC's rules, should evaluate the presentation of the elements that management is required to present in its annual report on internal control over financial reporting.[66]

If the auditor identified material weaknesses[67] during the audit, he or she must communicate them in writing to the management and the audit committee[68] of the corporation.[69] If the auditor concludes that the oversight of

[60] ¶ 63.

[61] Auditing Standard No. 12, ¶ 20.

[62] ¶ 38

[63] ¶ 54.

[64] Auditing Standard No. 12, ¶ 57.

[65] Auditing Standard No. 5, ¶ 71.

[66] ¶ 72.

[67] If there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor must express an adverse opinion on the company's internal control over financial reporting. Auditing Standard No. 5, ¶ 90.

[68] In addition, the auditor should report any deficiencies, or combination of deficiencies, that he or she identified during the audit that may be considered significant deficiencies in writing to the audit committee. Auditing Standard No. 5, ¶ 80.

[69] Auditing Standard No. 5, ¶ 78.

the corporation's external financial reporting and internal control over financial reporting[70] by the company's audit committee is ineffective, the auditor must communicate such conclusion in writing to the board.[71]

If the auditor has an adverse opinion on internal control, the auditor should determine the effects of this opinion on the corporation's financial statements. The auditor should also disclose whether the opinion on the financial statements was affected by the adverse opinion on internal control.[72]

Finally, the auditor is obligated to inquire from management whether there were changes in internal control over financial reporting or any other relevant factors that might occur after the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. The auditor should obtain written representations from management regarding these changes.[73] If the auditor discovers subsequent events that materially and adversely affect the effectiveness of the company's internal control over financial reporting as of the date specified in the assessment, the auditor should issue an adverse opinion on internal control over financial reporting. The auditor should disclaim the opinion if he or she is unable to determine the effects of these subsequent events on the effectiveness of the company's internal control over financial reporting.[74] If subsequent events that relate to conditions that did not exist at the date of assessment arise and have material effects on the corporation's internal control over financial reporting, the auditor must likewise describe the subsequent events and their effects on the corporation's internal control.[75]

The auditor's gatekeeping function does not end here. If he or she previously reported a material weakness and it[76] continues to exist, he or she is obliged to report that this material weakness continues to exist.[77]

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[70] The auditor also should communicate to management, in writing, all deficiencies in internal control over financial reporting (i.e., those deficiencies in internal control over financial reporting that are of a lesser magnitude than material weaknesses) identified during the audit and inform the audit committee when such a communication has been made. Auditing Standard No. 5, ¶ 81.

[71] Auditing Standard No. 5, ¶ 79.

[72] ¶ 92.

[73] ¶ 93.

[74] ¶ 96.

[75] ¶ 97.

[76] A "previously reported material weakness" means a material weakness that was described previously in an auditor's report issued pursuant to Auditing Standard No. 5.

In this case, the auditor is tasked to obtain reasonable assurance about whether the previously reported material weakness exists as of a date specified by management. The auditor should then express an opinion based on this reasonable assurance. This specific opinion will only pertain to the existence of the previously reported material weakness and not to the effectiveness of the corporation's internal control over overall financial reporting.[78] The auditor should then use the same framework that he or she previously used to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting. This means using the same control criteria and the same corporate objectives for evaluation.[79]

For due process considerations, management will be afforded the opportunity to explain the continuing existence of the previously reported material weakness. It must state its responsibility for establishing and maintaining effective internal control over financial reporting,[80] and identify the control criteria that it used to conduct the required annual assessment of the effectiveness of the corporation's internal control over financial reporting.[81] It should then proceed to the identification of the control objectives of the corporation and the achievement of such control objectives.[82] Finally, it should identify this previously reported material weakness and manifest that the controls have already addressed this previously reported material weakness.[83]

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[77] An auditor may conduct an engagement to report on whether a previously reported material weakness continues to exist if (1) the auditor has audited the company's financial statements and internal control over financial reporting in accordance with Auditing Standard No. 5 as of the date of the company's most recent annual assessment of internal control over financial reporting, or (2) the auditor has been engaged to perform an audit of the financial statements and internal control over financial reporting in accordance with Auditing Standard No. 5 in the current year and has a sufficient basis for performing this engagement. Auditing Standard No. 4, Reporting on Whether a Previously Reported Material Weakness Continues to Exist, PCAOB Release 2005-015, ¶ 2.

[78] Auditing Standard No. 4, ¶ 5.

[79] Auditing Standard No. 5, ¶ 5.

[80] Auditing Standard No. 4, ¶ 48 (a).

[81] ¶ 48 (b).

[82] ¶ 48 (d).

[83] ¶ 48 (e).

From this report, the auditor will proceed to evaluate management's statements. The auditor must conclude through an opinion whether or not management properly stated, conducted the proper evaluations, and correctly addressed the previously reported material weakness that continues to exist.[84] The auditor is likewise obliged to inquire about subsequent events that may affect the effectiveness of the identified controls or the achievement of the stated control objective as of the date specified in management's assertion.[85] If management offers any new additional information, the auditor should discuss this with management. The auditor should inform its views in writing to both management and to the audit committee.[86]

In all cases where the auditor concludes that a previously reported material weakness continues to exist, it must communicate this to the corporation's audit committee.[87]

C. Legal Profession Standards

The Lawyer as Gatekeeper[88]

The United States Congress enacted Sarbanes-Oxley to provide for more accountability and better corporate governance measures following the various accounting debacles in 2000 and 2001. Former President George W. Bush described it as incorporating "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."[89] It was intended to "establish investor confidence by improving the quality of corporate disclosure and financial reporting, strengthen the independence of

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[84] ¶¶ 49 (a-d).

[85] ¶ 58.

[86] ¶ 60.

[87] ¶¶ 61-63.

[88] The concept of a lawyer as a gatekeeper was included in a paper previously published in the Philippine Law Journal. Maria Carmen L. Jardeleza, *Shotgun versus Top Gun: Confidentiality and the Filipino In-House Counsel,* 83 PHIL L.J. 94 (2008),("Jardeleza PLJ Paper"). These were further discussed in a paper submitted for Capital Markets: Development Structure and Regulatory Policies seminar class under Professor Meyer Eisenberg at Columbia Law School, Fall Semester 2011, entitled "The Philippine Lawyer and Sarbanes-Oxley: Gatekeeper or Lapdog?" ("Jardeleza-Eisenberg Paper").

[89] White House, *President Bush Signs Corporate Corruption Bill* (2002) *available at* http://www.whitehouse.gov/news/releases/2002/07/print/20020730.html, *as cited in* THOMAS BOST, THE SARBANES-OXLEY ACT OF 2002 1 (2003).

accounting firms, and increase the role and responsibility of corporate officers and directors in financial statements and corporate disclosures."[90] It has brought about increased extensive federal regulation of the accounting profession and of securities dealers.[91]

Sarbanes-Oxley Section 307[92] mandated the U.S. SEC to promulgate rules of professional conduct for lawyers who appear and practice before the U.S. SEC. These rules require such lawyers to report material violations of securities laws and other failures of legal compliance to the highest levels of corporate authority.[93] Section 307 provides:

> "No later than 180 days after the date of enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule –
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> (1) **requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof)**; and,
>
> (2) if the **counsel or officer does not appropriately respond** to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), **requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors**." (Emphasis supplied)

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[90] Bost, *supra* note 1, at 1.

[91] Report of the American Bar Association Task Force on Corporate Responsibility, 6-7, *available at* http://www.americanbar.org/content/dam/aba/migrated/leadership/2003/journal/119c.authcheckdam.pdf> (last modified Nov. 7, 2011 5:00 p.m. EDT).

[92] Sarbanes-Oxley Rule 307, Rules of Professional Responsibility for Attorneys.

[93] Report of the American Bar Association Task Force on Corporate Responsibility, 8, *available at* http://www.americanbar.org/content/dam/aba/migrated/leadership/2003/journal/119c.authcheckdam.pdf (last modified Nov. 8, 2012 1:47 P.M. EDT) as cited in Jardeleza Eisenberg Paper, *supra* note 87, at 7.

Lawyers were criticized for failing to guard investors from corporate fraud. It was believed that lawyers who represent corporations easily accepted the representations made by corporations or its auditors regarding the substance of transactions that later on turned out to be fraudulent. As lawyers of the corporation, they were faulted for failing to perform the necessary due diligence. They were thought to have failed to press their views on the risks and exposures of transactions and other arrangements to management and the board. They were also faulted for having a weak and passive approach on disclosures to the public.[94]

The U.S. Congress, through Section 307, thus decided to make it mandatory for lawyers who practice before the U.S. SEC to report material violations of securities laws, breaches of fiduciary duties, or any similar violations. In case the designated officer does not appropriately respond, the reporting lawyer should report to the corporation's audit committee, to other board committee[s] composed of outside directors, or to the board itself.

There are thus two essential aspects to Section 307: the proactive reporting of fraud, as well as the up-the-ladder reporting procedure. On the surface, Section 307 may seem to be quite simple enough to comply with. It essentially advises a lawyer that if an illegal activity is done, it must be reported to an authority within the corporation. If that designated authority does not act upon such report, then the lawyer should go up to higher authority, until he or she will have exhausted all possible authorities involved.

The Challenges of Reporting under Section 307

Lawyers provide advice to public corporations through their directors, officers, and employees on compliance matters concerning the corporation's legal obligations. Lawyers, however, may be motivated to please the corporate officials with whom they deal, rather than preserve the best interests of the corporation. For instance, outside counsel may compete to acquire and retain client business.[95]

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[94] Jardeleza-Eisenberg Paper, at 7-8.
[95] *Id.*, at 14.

The situation is particularly delicate for a general counsel[96] or an in-house counsel of a corporation. An in-house counsel, who acts as a lawyer for the corporation, is an employee of the corporation and is not an independent lawyer. Generally, the in-house counsel advises the corporation on day-to-day matters. Larger corporations have legal departments with attorneys assigned to specialized areas of law affecting particular aspects of the business, such as labor law, taxes, personal injury litigation, and corporate law.[97]

The in-house counsel manages the legal affairs of the corporation, but is also directly employed by the corporation itself. The in-house counsel thus wears two hats at the same time: that of a lawyer and that of an employee.[98]

The desire to seek to please the corporate officials with whom they deal with[99] significantly influences the incentives that the in-house counsel may have in conducting the legal affairs of the corporation. For instance:

> If the single client is the corporation, its officers will have significant control over the lawyer's professional life – [his or] her title, income, assignments, office space, and support staff. Put [him or] her in a small city with two children headed for college and a hefty mortgage, and the plot does begin to thicken. While such facts are supposed to be irrelevant to the lawyer's professional conduct, realistically it may strongly influence how [he or] she reacts when faced with a duty to [his or] her client or others that the CEO suggests [he or] she ignore. ('Don't be such a Goody Two-Shoes. Learn how to play ball.')[100]

Professor Stephen Gillers describes some hypothetical situations that may arise in an in-house counsel's "donning of two hats." If a high-ranking officer of the corporation intends to implement a business decision that the in-house counsel believes is unwise but defensible, should the in-house counsel approve a legal but unprofitable venture? Should the in-house counsel allow a

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[96] The general counsel refers to the lawyer who has general supervisory responsibility for the legal affairs of the corporation. *Supra* note 19 at 21. An in-house counsel is the general term for a lawyer who is employed by the corporation. An in-house counsel may be a member of the general counsel's staff of lawyers.

[97] Jardeleza PLJ Paper, at 104.

[98] *Id.*

[99] Jardeleza-Eisenberg Paper, at 14.

[100] STEPHEN GILLERS, REGULATION OF LAWYERS: PROBLEMS OF ETHICS, 541 (6TH ED., 2002), as cited in Jardeleza PLJ Paper, at 107.

profitable venture that he or she knows may later on subject the corporation to antitrust liability? How will the in-house counsel manage an action that will personally benefit an officer but that which will violate the officer's fiduciary obligation to the corporation?[101]

The members of the American Bar Association Task Force on Corporate Responsibility[102] believe that lawyers play important roles in corporate governance and corporate responsibility. Lawyers employed by the corporation and outside lawyers retained by the corporation often serve as key advisers to senior management and usually participate in the negotiation, structuring, and documentation of the corporation's significant business transactions. Additionally, lawyers often serve as counselors to the board to assist it in performing its oversight function. In such roles, lawyers obviously do and should play a critical role in helping the corporation recognize, understand, and comply with applicable laws and regulations, as well as in identifying and evaluating business risks associated with legal issues.[103]

A prudent corporate governance program should thus call upon the lawyers, particularly the corporation's general counsel, to assist in the design and maintenance of the corporation's procedures for promoting legal compliance.[104] However, it becomes difficult for the in-house and general counsels when the board of directors and officers of the corporations exercise a significant amount of control over their careers as employees of the corporation. Lawyers should thus be afforded sufficient guidance in order to overcome these ethical conflicts and difficulties.

Sarbanes-Oxley Section 307: Federalization of Ethical Rules on Attorney Conduct

Section 307 of Sarbanes-Oxley as well as the Part 205 regulations of the Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer,[105] set forth "minimum standards of professional conduct" for lawyers post-Enron. As

[101] *Id.,* at 542.
[102] Jardeleza-Eisenberg Paper, at 14.
[103] *Id.*, at 20 to 21.
[104] *Id.*, at 20.
[105] Part 205 – Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 CFR §205 et seq.

such, these rules are not intended to limit the ability of the various states to impose additional professional obligations consistent with them, but they do preempt state rules if the state rules conflict with them.[106] Thus, Section 307 and its Part 205 regulations governing a lawyer's conduct are federalized.[107]

To reiterate, these standards are limited to lawyers who appear and practice[108] before the U.S. SEC. It does not include lawyers who, while appearing or practicing for the U.S. SEC, do so outside of a lawyer-client relationship. It also excludes non-appearing foreign lawyers.[109]

The general framework entails an up-the-ladder approach in the reporting of fraud. If a lawyer who appears and practices before the U.S. SEC in the representation of an issuer becomes aware of evidence of a material

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[106] "An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state…" Part 205 – Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, Rule 6(c), as cited in Jardeleza-Eisenberg Paper, at 11.

[107] Jardeleza-Eisenberg paper, at 11.

[108] "Appearing" and "practicing" means: (i) transacting any business with the U.S. SEC, including communications in any form; (ii) representing an issuer in a U.S. SEC administrative proceeding or in connection with any U.S. SEC investigation, inquiry, information request, or subpoena; (iii) providing advice in respect of the U.S. securities laws or the U.S. SEC rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the U.S. SEC, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or (iv) advising an issuer as to whether information or a statement, opinion, or other writing is required under the U.S. securities laws or the U.S. SEC's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the U.S. SEC. Part 205 – Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, Rule 2(a)(1), as cited in Jardeleza Eisenberg Paper, at 11.

[109] Non-appearing foreign attorneys are those who are (i) admitted to practice law in a jurisdiction outside the U.S.; (ii) who do not hold themselves out as practicing and do not provide legal advice on U.S. laws; (iii) who conduct activities that would constitute appearance and practice before the U.S. SEC only incidentally to the practice of law outside of U.S. jurisdiction; and (iv) who appear and practice before the U.S. SEC only in consultation with counsel licensed to practice in U.S. jurisdiction. Part 205 – Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, Rule 2(a)(2).

violation[110] caused by the issuer or by any officer, director, employee, or agent of the issuer, the lawyer should report such evidence to the issuer's chief legal officer or his or her equivalent, or to both the issuer's chief legal officer and its chief executive officer ("CEO") or their equivalents.[111]

If the reporting lawyer does not reasonably believe that the chief legal officer or the CEO of the issuer has appropriately responded to his or her report, the reporting lawyer must proceed to report the matter to the audit committee of the issuer's board, to another committee of the issuer's board which consists solely of directors who are not employed, directly or indirectly, by the issuer, or to the issuer's board.[112]

If the corporation has a qualified legal compliance committee,[113] a reporting lawyer may alternatively report evidence of material violations to this

[110] A "material violation" is a material violation of an applicable U.S. federal or state securities law, a material breach of fiduciary duty arising under U.S. federal or state law, or a similar material violation of any U.S. federal or state law. Part 205 – Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, Rule 2(i), as cited in Jardeleza Eisenberg Paper, at n.88, at 11.

[111] Part 205 – Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, Rule 3(a)(b), as cited in Jardeleza-Eisenberg Paper, at 12.

[112] Part 205 – Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, Rule 3(b)(3), as cited in Jardeleza-Eisenberg Paper, at 12.

[113] A "qualified legal compliance committee" is a committee of the issuer that (i) consists of at least one member of the issuer's audit committee, and two or more directors who are not, directly or indirectly, employed by the corporation; (ii) has adopted written procedures for the confidential receipt, retention and consideration of any report of evidence of a material violation; (iii) has been duly established by the issuer's board with the authority and responsibility to investigate and have authority to report to the U.S. SEC in case the issuer fails to implement an appropriate response that the qualified legal compliance committee has recommended. Part 205 – Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, Rule 2(k), as cited in Jardeleza Eisenberg Paper, at 12.

committee.[114] This qualified legal compliance committee may also receive the chief legal officer's referral of a report of evidence.[115]

D. Employee Whistleblower Protections

Employees as Whistleblowers

Sarbanes-Oxley protects employees of publicly-traded companies who provide evidence of fraud.[116] These are the so-called "whistleblowers."[117] Sarbanes-Oxley protects them from various forms of employer retaliation such as discharge, demotion, suspension, threat, harassment or any form of discrimination for lawfully providing information, filing, testifying, participating, or otherwise assisting in an investigation that the whistleblower employee believes is a violation of Sections 1341, 1343, 1344, or 1348, any U.S. SEC rule or regulation, or any provision of federal law relating to fraud against shareholders.[118] The investigation must be conducted by a federal regulatory or law enforcement agency, a member of the U.S. Congress or any of its committees, or a person with supervisory authority over the whistleblower employee.[119]

Any whistleblower employee who was retaliated against may file a complaint with the Department of Labor's Occupational Safety and Health

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[114] Part 205 – Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, Rule 3(c)(1), as cited in Jardeleza Eisenberg Paper, at 12.

[115] Part 205 – Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, Rule 3(c)(2), as cited in Jardeleza Eisenberg Paper, at 12.

[116] Sarbanes-Oxley § 806, Protection for Employees of Publicly Traded Companies Who Provide Evidence of Fraud, which amended Chapter 73, Title 18 U.S.C. and added a new § 1514A.

[117] Generally, a "whistleblower" is an employee who discloses information that he or she reasonably believes is evidence of illegality, gross waste or fraud, mismanagement, abuse of power, general wrongdoing, or a substantial and specific danger to public health and safety. Government Accountability Project, *available at*http://www.whistleblower.org/about/what-is-a-whistleblower (last visited Nov. 15, 2012 at 7:34 P.M. EDT). This paper focuses on whistleblowers who report corporate and securities fraud.

[118] 18 U.S.C. §1514A (a).

[119] § 1514A (a).

Administration ("OSHA")[120] If the OSHA does not act within 180 days, the whistleblower may proceed to file a case with the district court.[121] The whistleblower employee is entitled to all reliefs necessary to make him or her whole.[122] These reliefs include compensatory damages that include (i) reinstatement with the same seniority status that the employee would have had but for the discrimination,[123] (ii) back pay with interest,[124] (iii) compensation for special damages caused by the discrimination such as litigation costs, expert witness fees, and lawyer fees.[125]

Other Informants and Reporters

Sarbanes-Oxley also protects against retaliation those who come forward with information for the possible commission of a federal offense. Any person who knowingly, with the intent to retaliate, harms any person, including interfering with the person's lawful employment or livelihood, for providing truthful information regarding a possible federal offense to a law enforcement officer, shall be fined or imprisoned for not more than 10 years.[126]

E. Dodd-Frank Whistleblower Program

Dodd-Frank added further protections for whistleblowers by amending the Exchange Act and inserting a new section, Section 21F, on Securities Whistleblower Incentives and Protections.[127] Section 21F mandates the U.S. SEC to monetarily award eligible individuals who voluntarily provide original information that lead to successful enforcement actions resulting in monetary sanctions of over US$1,000,000. These awards are at least 10%, but no more than 30%, of the monetary sanctions collected. These awards are to be paid out from an Investor Protection Fund.[128] Dodd-Frank likewise

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[120] § 1514A (b)(1)(A).
[121] § 1514A (b)(1)(B).
[122] § 1514A (c)(1).
[123] § 1514A (c)(2)(A).
[124] § 1514A (c)(2)(B).
[125] § 1514A (c)(2)(C).
[126] Sarbanes-Oxley § 1107, Retaliation Against Informants, which amended § 1513 of 13 U.S.C. by adding item (e).
[127] Dodd-Frank § 922, Whistleblower Protection.
[128] § 922(g)(1).

directed the U.S. SEC to create a separate office to administer this whistleblower program.[129] On May 25, 2011, the U.S. SEC adopted the final rules.[130]

Under this program, a whistleblower is a person acting individually or jointly with others in providing information about a possible violation of federal securities laws, rules or regulations to the U.S. SEC. A corporation or any other entity is not entitled to be a whistleblower.[131]

A whistleblower's report is considered as confidential, unless it is required to be disclosed in connection with a case in a federal court, in an administrative action filed by the U.S. SEC, or in another public action or proceeding by an authority to whom the U.S. SEC provided the information.[132] In addition, the U.S. SEC may release the information to other offices and agencies such as the Department of Justice, the PCAOB, or a state attorney general in order to accomplish the objectives of the Exchange Act and to protect investors.[133]

A whistleblower may provide the information to the U.S. SEC anonymously. However, he or she must have lawyer representation in the submission of the information and the claim for the award.[134] The whistleblower's identity must eventually be disclosed when claiming the award.[135]

In addition to the necessary requirements in the Form TCR[136] and a declaration that the information is true and correct to the best of the knowledge and belief of the whistleblower under pain of perjury,[137] there are other eligibility requirements for an award. For instance, a potential whistleblower must not be employed by the U.S. SEC, the Department of Justice, an appropriate regulatory agency, a self-regulatory organization, the

[129] This is known as the Office of the Whistleblower, whose creation was mandated by Sarbanes-Oxley § 924(d).

[130] Regulation 21F, Final Rules of the Securities Whistleblower Incentives and Protection, Release No. 34-64545. (August 12, 2011) ("Regulation 21F Final Rules").

[131] § 240.21F-2(a).

[132] § 240.21F-7(a)(1).

[133] § 240.21F-7(a)(2).

[134] § 240.21F-7(a)(3)(b)(1).

[135] § 240.21F-7(a)(3)(b)(3).

[136] § 240.21F-9(a). "Tip, Complaint or Referral Form."

[137] § 240.21F-9(b).

PCAOB, or any law enforcement organization.[138] Neither should the whistleblower be a member, officer or employee of a foreign government, its instrumentalities, or any foreign financial regulatory authority.[139] The whistleblower must also not have been convicted of a criminal violation that is related to an action by the U.S. SEC for which the whistleblower would have received the award.[140] The whistleblower must not have performed an audit of the corporation's financial statements. The submission of the whistleblowing information would violate Section 10A[141] of the Exchange Act.

A whistleblower also cannot be a spouse, parent, child, or sibling of a member or employee of the U.S. SEC, or reside in the same household as a member or employee of the U.S. SEC.[142] The information must also not have been obtained through any person who may be covered by these eligibility standards, or with the intent to evade any of these rules.[143] Finally, the whistleblower must not knowingly and wilfully make any false, fictitious, or fraudulent statements or representations. Neither shall the whistleblower use any false writing or document knowing that it contains any false, fictitious, or fraudulent statement or entry with intent to mislead or otherwise hinder the U.S. SEC or another authority.[144]

The whistleblower's information must also be voluntarily made to the U.S. SEC,[145] the PCAOB or any self-regulatory organization,[146] the U.S. Congress, the federal government, the state lawyer general, or any securities regulatory authority.[147] The information is not voluntary if it was requested, inquired, or demanded by any of these offices or agencies. However, it remains voluntary if the information was voluntarily provided to these other offices or agencies prior to a request, inquiry, or demand by the U.S. SEC.[148]

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[138] § 240.21F-8(c)(1).
[139] § 240.21F-8(c)(2).
[140] § 240.21F-8(c)(3).
[141] § 240.21F-8(c)(4). This pertains to auditing standards such as reports to the audit committee, conflicts of interest, and standards for audit committees.
[142] § 240.21F-8(c)(5).
[143] § 240.21F-8(c)(6).
[144] § 240.21F-8(c)(7).
[145] § 240.21F-4(a)(1)(i).
[146] § 240.21F-4(a)(1)(ii).
[147] § 240.21F-4(a)(1)(iii).
[148] § 240.21F-4(a)(2).

The U.S. SEC's Final Rules are strict about what constitutes whistleblower information. First, this information must be original. Information is considered original if it is (i) derived from the whistleblower's own independent knowledge[149] or independent analysis,[150] (ii) not already known to the U.S. SEC from any other source,[151] (iii) not exclusively derived from an allegation made in a judicial or administrative hearing, a government report, hearing, audit, investigation or from the news media,[152] and is provided by the whistleblower after the enactment of Dodd-Frank.[153]

The information must result in successful enforcement that leads to a monetary sanction of at least US$1,000,000.[154] The award[155] to the whistleblower will be at least 10% but not exceeding 30% of the monetary sanctions that arise from the successful enforcement.[156] If there are several

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[149] § 240.21F-4(b)(2). "Independent knowledge" means factual information that the whistleblower did not derive from public sources. This may include information that the whistleblower obtained from his experiences and observations in business and social interactions.

[150] § 240.21F-4(b)(i). "Independent analysis" should be analysis done by the whistleblower himself, whether alone or with others. This analysis is an examination of information that is publicly available, but which later on reveals information that is not generally known to the public.

The information will not be considered as derived from the whistleblower's independent knowledge or independent analysis if (i) the information is privileged under attorney-client privilege; (ii) the information was obtained through the course of his or her legal representation of a client and the whistleblower intended to submit the information for his or her own benefit, unless he or she made a prior disclosure to his or her client; (iii) the whistleblower is an officer, trustee or partner of an entity and he or she obtained the information from another person or during an examination of the entity's processes for identifying and addressing violations of the law; (iv) the whistleblower has compliance or internal audit functions within the entity or retained by a firm engaged to perform the same for the entity; (v) the whistleblower is employed by the firm to investigate possible violations of the law; (vi) the whistleblower is an employee of a public accounting firm where he or she obtained the information through an audit of the firm; and (vii) the whistleblower obtained the information by means that a U.S. court would deem to violate the laws. Regulation 21F Final Rules, § 240.21F-4(b)(i) to (vii).

[151] § 240.21F-4(b)(ii).

[152] § 240.21F-4(b)(iii).

[153] § 240.21F-4(b)(iv).

[154] § 240.21F-4(d)(2).

[155] Payments of these awards shall come from the SEC Investor Protection Fund that was established by § 922(g)(1) of Dodd-Frank.

[156] Regulation 21F Final Rule, § 240.21F-5(b).

whistleblowers acting jointly, the amounts shall be considered in the aggregate.[157]

The final amount of the whistleblower's award is discretionary upon the U.S. SEC on several factors. For instance, the U.S. SEC will consider the significance and degree of relevance of the whistleblower's information to the success of the U.S. SEC's action or related action.[158] The U.S. SEC will also look into whether the whistleblower was cooperative in providing assistance throughout the course of the action.[159] The quality of the whistleblower's information will also be assessed. For example, the U.S. SEC is interested in the kind of information that will expose industry-wide practices and in the degree of the severity of harm that will be caused to investors.[160] Finally, the U.S. SEC will also consider whether the whistleblower utilized a firm's legal and internal compliance systems prior to reporting to the U.S. SEC.[161]

Potential whistleblowers are protected by anti-retaliation measures whether or not they satisfy the requirements, procedures, and conditions to qualify for an award.[162] The potential whistleblower must possess a reasonable belief that the information he or she is providing relates to a possible securities violation that has occurred, is occurring, or is about to occur.[163] In addition, the potential whistleblower must have been the subject of discharge, demotion, suspension, threat, harassment, or any form of discrimination in his or her employment due to any lawful act by the whistleblower in providing the information to the U.S. SEC as well as in initiating, testifying, or assisting in any investigation by the U.S. SEC, or in making disclosures that are protected under Sarbanes-Oxley.[164]

Any potential whistleblower who has been retaliated upon may file an action in the appropriate district court for the proper relief.[165] These reliefs shall include reinstatement with the same seniority that the individual would have had but for the discrimination,[166] two times the amount of back pay with

[157] § 240.21F-5(c).
[158] § 240.21F-6(a)(1).
[159] § 240.21F-6(a)(2).
[160] § 240.21F-6(3).
[161] § 240.21F-6(4).
[162] § 240.21F-2(b)(2).
[163] § 240.21F-2(b)(1).
[164] § 240.21F-2(b)(2). These disclosures are protected under § 806 of Sarbanes-Oxley.
[165] Exchange Act, § 21F(h)(B)(i).
[166] § 21F(h)(C)(i).

interest,[167] and compensation for litigation costs, expert witness fees, and reasonable lawyer's fees.[168]

Potential whistleblowers whose information does not qualify as original may still report the same under certain exceptions. For instance, notwithstanding that the whistleblower is an officer, trustee or partner of an entity, has compliance or internal audit duties within the firm, is retained to investigate possible violations of the law, is an employee of a public accounting firm tasked to audit the firm, or obtained the information in violation of the laws, the whistleblower's information may still be considered as original information if he or she has a reasonable basis to believe that the information pertains to conduct of the entity that may cause substantial injury to the financial interest or property of the entity or investors.[169] In addition, the whistleblower may also disclose the information as original if he or she has reasonable basis to believe that the entity is engaging in conduct that may impede an investigation of the misconduct.

If a whistleblower first internally reports to his or her direct supervisor, corporation's audit committee, chief legal officer, chief compliance officer, and these persons do not act on the whistleblower's information after 120 days, the whistleblower's information will still be considered original information that may be reported out to the U.S. SEC Whistleblower Award Program.[170]

U.S. SEC's Office of the Whistleblower

The U.S. SEC's Office of the Whistleblower is the division that implements the Dodd-Frank Whistleblower Awards Program. It started its operations around May 2011. It has provided its staff with extensive training on Regulation 21F. It has also drafted internal policies and continually promoted the office through speeches, press releases, and the like. A hotline was set up and a website was created. In addition, the Office of the Whistleblower started to coordinate with other related agencies that have

[167] § 21F(h)(C)(ii).
[168] § 21F(h)(C)(iii).
[169] Regulation 21F, § 240.21F-2(b)(4)(v)(A).
[170] § 240.21F-2(b)(4)(v)(C).

similar whistleblowing programs such as the Internal Revenue Service and the Department of Justice, among others.[171]

Because Regulation 21F became effective only on August 12, 2011, the Office of the Whistleblower was able to report only seven weeks of whistleblower tip data for fiscal year 2011, and yet there were 334 whistleblowing tips received between August 12, 2011 and September 30, 2011. The most common whistleblowing tips were on market manipulation (16.2%), corporate disclosures and financial statements (15.3%), and offering fraud (15.6%). The U.S. SEC received whistleblower submissions from individuals in 37 states, as well as from several foreign countries, including China and the United Kingdom.[172] In addition, applications for awards have not yet been processed since the 90-day application period has not yet been passed with respect to any Notices of Covered Actions[173] as of the end of the fiscal year. Therefore, no whistleblower awards have been paid out as of the time of this writing.[174]

More Employees as Whistleblowers

Dodd-Frank expanded the protections of Sarbanes-Oxley Section 806[175] to employees of the subsidiaries and affiliates of publicly traded companies.[176]

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[171] Office of the Whistleblower Annual Report on the Dodd-Frank Whistleblower Program, Fiscal Year 2011, 4, *available at*http://www.sec.gov/about/offices/owb/whistleblower-annual-report-2011.pdf(last modified Nov.9, 2012 at 2:34 A.M. EDT)("Office of the Whistleblower Annual Report").

[172] Office of the Whistleblower Annual Report, at 7.

[173] A "Notice of Covered Action" is a notice published at the website of the Office of the Whistleblower that a U.S. SEC action results in monetary sanctions totalling more than US$1,000,000. This notice is published subsequent to the entry of final judgment or order. A claimant has 90 days from the date of the Notice of Covered Action to file a claim for an award based on that action, or the claim will be barred. Regulation 21F Final Rules, § 240.21F-10(a).

[174] Office of the Whistleblower Annual Report, at n.176.

[175] Dodd-Frank § 806, Protection for Employees of Publicly Traded Companies Who Provide Evidence of Fraud.

[176] Dodd-Frank§ 929A.

F. NYSE Euronext Complaint Procedures for Accounting and Auditing Matters

The New York Stock Exchange Euronext ("NYSE Euronext") has a Code of Ethics[177] that requires that a corporation's business records, whether financial or otherwise, to be accurately created and reported with integrity. The corporation is responsible for the integrity of the information, reports, and records under its control. Financial books, records, and accounts must be prepared in accordance with generally accepted accounting principles and with the NYSE Euronext system of internal controls.[178] Any NYSE Euronext filings must be accurate and filed in a timely manner.[179]

This Code of Ethics also describes a whistleblowing reporting policy. If a person believes in good faith that a provision of the NYSE Euronext Code of Ethics was breached, he or she should inform his or her manager, compliance officer, or other designated person in accordance with local policies and procedures.

The NYSE Euronext Complaint Procedures for Accounting and Auditing Matters[180] has a global whistleblowing policy for anyone with a complaint in good faith regarding a breach of NYSE Euronext's accounting, internal accounting controls or auditing matters to communicate this complaint directly to the NYSE Euronext chief compliance officer or Audit Committee.[181] All reports are investigated confidentially. Anti-retaliation measures are also provided to protect those who come forward with whistleblowing information.[182]

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177 NYSE Euronext Code of Ethics and Business Conduct.

178 As a publicly listed corporation, NYSE Euronext is also required to file Form 10-K and other reports.

179 NYSE Euronext Code of Ethics and Business Conduct, at 6.

180 Also known as the NYSE Euronext's "Whistleblowing Policy."

181 NYSE Euronext 2012 Proxy Statement *available at* https://materials.proxyvote.com/Approved/629491/20120228/NPS_121349/HTML2/nyse_euronext-proxy2012_0032.htm/ (last modified Nov.9, 2012 at 2:01 A.M. EDT).

182 NYSE Euronext Code of Ethics and Business Conduct, at n.180, at 8.

NASDAQ OMX Hotline

The National Association of Securities Dealers Automated Quotation OMX ("NASDAQ OMX")[183] offers corporations an option for the setting up of a global, fully-automated Whistleblower Hotline. It provides a sender-to-receiver capability without risk of human intervention, thus bolstering privacy and confidentiality for whistleblowers. It likewise provides secure, auditable, and an easy-to-use message management environment. It can employ broad-based communication methods that can capture all communications in whatever local language for the corporation to review and resolve.[184]

PART II: THE PHILIPPINE INTERNAL CONTROLS SYSTEM

A. Internal Controls

The Philippines has generally adopted the reforms brought about by Sarbanes-Oxley. The Philippine Securities and Exchange Commission ("Philippine SEC") has promulgated rules and regulations that closely follow the U.S. framework. Insofar as public and/or listed corporations are concerned, there are requirements that are similar to those required of U.S. public and/or listed corporations, among which are qualifications for board members,[185] requirements for independent directors,[186] separate CEO and chairman of the board positions,[187] audit committees,[188] nomination committees,[189] compensation and remuneration committees,[190] rotation of

[183] NASDAQ OMX is a publicly listed corporation that is required to file Form 10-K and other reports.

[184] NASDAQ OMX Whistleblower Hotline, *supra* note 8.

[185] Revised Code of Corporate Governance, SEC Memorandum Circular No. 6, Series of 2009, arts. 3(D)-(E), *available at* http://www.sec.gov.ph/laws/corporate_governance/Revised%20Code%20CG.pdf (Nov. 10, 2012 9:32 P.M. EDT).

[186] Art. 3(A).

[187] Art. 3(C).

[188] Art. 3(K)(i).

[189] Art. 3(K)(ii)(a).

[190] Art. 3(K)(ii)(b).

external auditors,[191] and annual, quarterly, current, predecessor and successor reports.[192]

In terms of internal controls, the Philippine Revised Code of Corporate Governance of 2009[193] describes, in general terms, the internal control responsibilities of the board of directors of a corporation. Boards of directors are mandated to have a control environment that consists of: (i) a board which ensures that the corporation is properly and effectively managed and supervised, (ii) management that actively manages and operates the corporation in a sound and prudent manner, (iii) organizational and procedural controls supported by effective management information and risk management reporting systems, and (iv) an independent audit mechanism to monitor the adequacy and effectiveness of the corporation's governance, operations, and information systems, including the reliability and integrity of financial and operational information, the effectiveness and efficiency of operations, the safeguarding of assets, and compliance with laws, rules, regulations, and contracts.[194]

The Philippine Revised Code of Corporate Governance suggests the following minimum requirements for an effective internal control mechanism: (i) a definition of the duties and responsibilities of the CEO who is ultimately accountable for the corporation's organizational and operational controls,[195] (ii) the selection of the CEO,[196] (iii) an evaluation of proposed senior management appointments,[197] (iv) the selection and appointment of qualified and competent management officers,[198] and (v) a review of the corporation's human resource policies, conflict of interest situations, compensation program for employees, and management succession plan.[199] It thus provides the bare minimum in terms of standards for an effective internal control system.

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[191] Art. 5(A)(v).

[192] Amended Implementing Rules and Regulations of the Securities Regulation Code (2004), ("SRC") SRC Rule 17.1 on Reportorial Requirements.

[193] SEC. Memo. Circ. No. 6 (s. 2009).

[194] Art. 3(H).

[195] Art. 3(H)(i).

[196] Art. 3(H)(ii).

[197] Art. 3(H)(iii).

[198] Art. 3(H)(iv).

[199] Art. 3(H)(v).

Philippine SEC Form 17-A[200] is the equivalent of Form 10-K.[201] Its instruction form is only seven pages long. The more detailed instructions similar to Regulation S-K are contained in an Annex C, as amended.[202] Part V of Annex C pertains to the information required of the issuer on the item under corporate governance for Philippine SEC Form 17-A.[203] Annex C may be considered as a very short version of Regulation S-K.[204]

Annex C requires that the issuer describe the following in Philippine SEC Form 17-A under the item "Corporate Governance:"[205] (i)the evaluation system established by the corporation to measure or determine the level of compliance of the board and top-level management with its Manual of Corporate Governance,[206] (ii) the measures being undertaken by the corporation to fully comply with the adopted leading practices on good corporate governance, (iii) any deviation from the company's Manual of Corporate Governance, which shall include a disclosure of the name and position of the person or persons involved, and the sanction/s imposed on said individual or individuals, and (iv) any plan to improve corporate governance of the company.

These are the only requirements that need to be reported in the Philippine SEC Form 17-A insofar as internal controls are concerned. In fact, these are the only requirements to be reported under the item "Corporate Governance." These are effectively the equivalent of reporting under Regulation S-K Item 307.[207] This is mainly a report on the effectiveness of the registrant's disclosure controls and procedures.

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[200] SEC Form 17-A, as amended, (2001), Annual Report Pursuant To Section 17 of The Securities Regulation Code ([Republic Act No. 8799], 2000) and Section 141 Of The Corporation Code ([*Batas Pambansa* Blg. 68], 1980).

[201] Form 10-K, at n. 21.

[202] Non-Financial Disclosure Requirements, SRC Rule 12.1, Requirements for Filings Pursuant to the Securities Regulation Code and the Corporation Code of the Philippines.

[203] Part IV, Corporate Governance, Item 13.

[204] Regulation S-K, at n. 22.

[205] *Supra* note 204.

[206] Every public and/or listed corporation is supposed to publish its own internal manual of corporate governance to establish and implement their corporate governance rules according to the Revised Code of Corporate Governance. Revised Code of Corporate Governance, at n. 186, Art. 9.

[207] Disclosure Controls and Procedures, *supra* note 23.

However, unlike Regulation S-K, Part V of Annex C does *not* require an internal control report over financial reporting for Philippine SEC Form 17-A. There is thus no counterpart Item 308 requirement.[208] The Philippine disclosure system is thus deficient in terms of internal control reporting when it comes to internal control over *financial* reporting. Since no internal control report over financial reporting is required, there are no equivalent provisions for corporate responsibility for financial reporting. For instance, there are no signing officer certifications that there are no material misstatements made, or that the financial statements fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report, among others.[209] Philippine SEC Form 17-A is merely signed by the CEO and the comptroller without any representations or statements similar to those required by Sarbanes-Oxley Section 302.[210] Of course, a corporation may voluntarily make internal control reports regarding financial reporting, but they are not specifically required by the Philippine SEC rules and regulations.

B. Philippine auditors as the only gatekeepers

As discussed above, Philippine SEC Form 17-A lacks the equivalents of Regulation S-K Item 308[211] and Sarbanes-Oxley §302.[212] However, the Philippine auditing standards try to fill in these gaps. Philippine auditors are mandated to make the board and corporate officers aware of their corporate responsibility for financial statements. They are required to obtain certain representations similar to those required under Sarbanes-Oxley Section 302.

The auditing standards in the Philippines are based on Philippine Standards on Auditing issuances by the Auditing Standards Practicing Council. These are further based on International Standards on Auditing ("ISAs") issued by the International Auditing Practices Committee of the International Federation of Accountants.[213] The International Federation of Accountants

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[208] Regulation S-K, Item 308, *supra* note 25.

[209] Sarbanes-Oxley § 302, et seq., Corporate Responsibility for Financial Reports.

[210] § 302.

[211] § 302, Internal Control over Financial Reporting.

[212] § 302, Corporate Responsibility for Financial Reporting.

[213] Philippine Standard on Auditing 120, Framework of Philippine Standards on Auditing, 3, *available at*

promotes convergence with respect to the standards issued by boards as well as to the International Financial Reporting Standards ("IFRSs")[214] set by the International Accounting Standards Board.[215]

It should be noted that financial statements are filed as a part of Philippine SEC Form 17-A.[216] In the preparation of financial statements, the board of directors and management sign a Statement of Management's Responsibility for Financial Statements ("Statement of Management's Responsibility").

In this Statement of Management's Responsibility, the management acknowledges its responsibility for the information and representations contained in the financial statements for a given fiscal year. They attest that the financial statements have been prepared in conformity with generally accepted accounting principles and that the figures contained therein are based on best estimates with the informed judgment of management concerning materiality. Management confirms that it maintains a system of accounting and reporting that provides for the necessary internal controls to ensure that transactions are properly authorized and recorded, that assets are safe from unauthorized use or disposition, and that liabilities are properly accounted for. The management likewise discloses to the corporation's audit committee and external auditor (i) all significant deficiencies in the design or operation of internal controls that could adversely affect its ability to record, process, and report financial data, (ii) material weaknesses in the internal controls, and (iii) any fraud that involves management or other employees who exercise significant roles in internal controls.[217]

The board is responsible for reviewing the financial statements before these are approved and submitted for the consideration of the stockholders. There is likewise a statement, although not signed in the Statement of Management's Responsibility by the independent auditors, that the

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http://www.aasc.org.ph/downloads/PSA/publications/PDFs/PSA-120.pdf(Nov. 10, 2012 at 2:25 A.M. EDT).

[214] *Available at* http://www.ifac.org/about-ifac/organization-overview/faq (last visited Nov. 10, 2012 at 2:21 A.M. EDT).

[215] The Philippines shifted from generally accepted accounting principles (GAAP) to IFRS on Jan. 1, 2005, *available at*www.sec.gov.ph (last visited Nov. 10, 2012 at 2:21 A.M. EDT).

[216] Form 17-A, Part 1, Item 7.

[217] Amended Implementing Rules and Regulations of the Securities Regulation Code, Rule 68.1(3)(a), as amended (2005)

independent auditors appointed by the stockholders have examined the financial statements of the corporation in accordance with generally accepted accounting principles. It further states that the independent auditors have expressed an opinion on the fairness of the presentation of the financial statements upon completion of such examination, in its report to the board and stockholders. This Statement of Management's Responsibility is then finally signed by the Chairman of the Board, the CEO, and the CFO. [218]

According to general Philippine auditing standards, the auditors should require statements from the board and management regarding corporate responsibility for internal controls in financial reporting.[219] However, these statements are not separately required to be included in Philippine SEC Form 17-A compared to those specifically required by Regulation S-K Item 308. The board and management do not make similar statements at the level of the annual report itself. Thus, it may seem that the gatekeeping function of Philippine auditors does not extend beyond the financial statements. The statements on corporate responsibility for financial reports are embedded within the financial statements, but do not extend to encompass the annual report itself.

The gatekeeping function of Philippine auditors is basically the same as that of U.S. auditors. According to Philippine Standards on Auditing,[220] the purpose of an audit is to enhance the confidence of users of financial statements. This purpose is attained by an opinion of the auditor on whether the financial statements are prepared, in all material respects, according to an applicable financial reporting framework. Generally, this framework entails an analysis as to whether the financial statements were presented fairly in all material respects in accordance with such framework.[221] There are also corresponding statements of management responsibility required for the preparation of the financial statements.[222]

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[218] Rule 68.1(3)(a), as amended (2005).

[219] Philippine Standard on Auditing 580, Written Representations, *available at* http://www.aasc.org.ph/downloads/PSA/publications/psa-580-revised-redrafted.php (last visited Nov. 10, 2012 at 2:34 A.M. EDT).

[220] Philippine Standard on Auditing 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Philippine Standards on Auditing, 3, *available at*http://www.aasc.org.ph/downloads/PSA/publications/PDFs/PSA-200-Revised-and-Redrafted.pdf (last visited Nov. 12, 2012 at 10:02 P.M. EDT).

[221] *Id.*

[222] Philippine Standard on Auditing 580, Written Representations.

The auditor must obtain reasonable assurance that the financial statements as a whole are free from material misstatements, whether due to fraud or error.[223] The standard of reasonable assurance is determined when he or she has obtained sufficient appropriate audit evidence to reduce the risk that the auditor will express an inappropriate opinion when the financial statements are materially misstated.[224]

The Philippine Standards on Auditing require auditors to exercise professional judgment throughout the planning and the performance of the audit, including: (i) the identification and assessment of risks of material misstatement, whether due to fraud or error, based on an understanding of the firm and its internal control environment, (ii) the obtaining of sufficient and appropriate audit evidence about whether material misstatements exists by designing and implementing appropriate responses to the assessed risks, and (iii) the forming of an opinion on the financial statement based on conclusions drawn from the audit evidence obtained.[225]

If an auditor cannot obtain reasonable assurance and a qualified opinion in the auditor's report will be insufficient to report to the users of the financial statements, the auditor is supposed to disclaim an opinion or withdraw from the engagement.[226]

There is likewise similar testing of controls when it comes to substantive analysis of procedures. The auditor should consider testing the operating effectiveness of controls over the issuer's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks.[227]

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[223] A misstatement or omission is considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users based on the financial statements. The auditor makes a judgment as to materiality in the light of surrounding circumstances. He or she also looks into the financial information needs of the users of the financial statements, by the size or nature of a misstatement, or a combination of both. Philippine Standard on Auditing 200, at 4.

[224] Philippine Standard on Auditing 200,, at 3.

[225] *Id.*

[226] Philippine Standard on Auditing 200, at 5.

[227] Philippine Standard on Auditing 520, Analytical Procedures, A13 at 6, *available at*http://www.aasc.org.ph/downloads/codified-standards/publications/PDFs/PSA-520.pdf (last visited Nov. 12, 2012 at 11:08 P.M. EDT).

The Philippine auditing standards require auditors to communicate to management any deficiencies in internal controls.[228] Philippine auditors are thus tasked to take the proactive approach for corporate responsibility on behalf of the board and management. Unless notified by the auditors, the board and management will not themselves act to identify and correct these deficiencies, as well as to issue statements on them because they are not required by Philippine SEC rules or regulations.

If the auditor discovers misstatements, he or she must also communicate this to the appropriate level of management. The auditor must identify each misstatement and request management to correct such.[229] If management refuses to correct some or all of these misstatements, the auditor should request the reasons for such and shall consider whether the financial statements as a whole are free from material misstatement in drafting the auditor's opinion.[230] The auditor shall also inform management of the effects of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.[231] The auditor shall also request a written representation from management whether they believe the effects of uncorrected misstatements are immaterial– individually and as a whole– to the financial statements as a whole.[232]

Philippine auditors are also supposed to review and assess previously reported uncorrected statements similar to the earlier discussion on previously

[228] A "deficiency in internal control" is a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing. A deficiency in internal control becomes a "significant deficiency in internal control when a deficiency or combination of deficiencies in internal control is, in the auditor's professional judgment, of sufficient importance to merit the attention of those charged with governance. Philippine Standard on Auditing 265, Communicating Deficiencies In Internal Control To Those Charged With Governance And Management, ¶ 6 at 3, *available at* http://www.aasc.org.ph/downloads/codified-standards/publications/PDFs/PSA-265.pdf (last visited Nov. 13, 2012 at 8:49 P.M. EDT).

[229] Philippine Standard on Auditing 450, Evaluation of Misstatements Identified During the Audit, ¶ 8 at 3,*available at* http://www.aasc.org.ph/downloads/codified-standards/publications/PDFs/PSA-450.pdf (last visited Nov. 12, 2012 at 11:28 P.M, EDT).

[230] ¶ 9 at 3.

[231] ¶ 13 at 4. *See also* Philippine Standard on Auditing 265, *supra* note 229, ¶10.

[232] ¶ 14 at 4.

reported material weakness for U.S. auditing standards. A Philippine auditor should look into (i) the size and nature of the misstatements and the particular circumstances of their occurrence, and (ii) their effects to prior periods on the relevant classes of transactions and on the financial statements as a whole.[233] If the auditor identifies a previously communicated significant deficiency that continues to exist, the auditor's current year communication may repeat or reference the description from the previous communication. The auditor may ask management why the significant deficiency has not yet been remedied. A failure of management to act, in the absence of a rational explanation, may in itself represent a significant deficiency.[234]

The communication and reports to management also follows the up-the-ladder approach in the U.S. First, the auditor must approach the persons who have the responsibility and authority to evaluate the deficiencies and to take the necessary remedial action.[235] For significant deficiencies,[236] the auditor should communicate with the CEO or chief financial officer ("CFO"), as well as other officers who are charged with governance.[237] For public and/or listed

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[233] ¶ 11 at 4.

[234] Philippine Standard on Auditing 265, ¶.A17 at 9.

[235] In other cases, the appropriate level may be also be that of operational management with more direct involvement in the control areas affected and with the authority to take appropriate remedial action. See also generally, Philippine Standard on Auditing 260 (Revised and Redrafted), Communication with Those Charged With Governance, *available at*http://www.aasc.org.ph/downloads/PSA/publications/PDFs/PSA-260-Revised-and-Redrafted.pdf (last visited Nov. 13, 2012 at 10:31 P.M. EDT).

[236] Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include (i) the likelihood of the deficiencies leading to material misstatements in the financial statements in the future; (ii) the susceptibility to loss or fraud of the related asset or liability; (iii) the subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates; (iv) the financial statement amounts exposed to the deficiencies; (v) the volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies; and (vi) the importance of the controls to the financial reporting process; for instance, general monitoring controls (such as oversight of management); controls over the prevention and detection of fraud; controls over the selection and application of significant accounting policies; controls over significant transactions with related parties; controls over significant transactions outside the entity's normal course of business; controls over the period-end financial reporting process (such as controls over non-recurring journal entries); the cause and frequency of the exceptions detected as a result of the deficiencies in the controls, and the interaction of the deficiency with other deficiencies in internal control. Philippine Standard on Auditing 265, ¶¶ A6 at 5-6.

[237] See also Philippine Standard on Auditing 265, ¶¶ A19 at 9 to 10.

corporations covered by the Philippine Revised Code of Corporate Governance, the board is primarily responsible for the governance of a corporation.[238]

Some indicators of significant deficiencies in internal control include: (i) the evidence of ineffective aspects of the control environment, such as indications that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance, identification of management fraud, whether or not material, that was not prevented by the entity's internal control, and management's failure to implement appropriate remedial action on significant deficiencies previously communicated, (ii) the absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established, (iii) the evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified, (iv) the evidence of an ineffective response to identified significant risks (for example, absence of controls over such a risk), (v) misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control, (vi) a restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud, and (vii) evidence of management's inability to oversee the preparation of the financial statements.[239]

In some cases, the identified deficiencies themselves may call into question the integrity or competence of management. For instance, there may be instances of fraud, intentional non-compliance with the laws and regulations, or inability of management to oversee the preparation of financial statements. In these cases, the auditor is supposed to communicate the matter to the next higher level of authority, such as an audit committee or the board. If there are no higher authorities involved, the auditor should seek legal advice.[240] In extreme cases, the auditor may have to report the identified or suspected non-compliance with the laws and regulations outside of the

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[238] Revised Code of Corporate Governance, Art. 3.

[239] Philippine Standard on Auditing 265, ¶¶ A7 at 6-7.

[240] Philippine Standard on Auditing 250 (Redrafted), Consideration Of Laws And Regulations In An Audit Of Financial Statements, ¶¶ 24 at 6-7,*available at* http://www.aasc.org.ph/downloads/PSA/publications/PDFs/PSA-250-Redrafted.pdf> (November 13, 2012 at 9:49 P.M. EDT.

entity.[241] The auditor may also communicate with third parties, such as a regulator or the shareholders. Finally, the auditor may withdraw from the engagement.[242]

The Philippine auditing standards mandate auditors to require several representations from management as to the latter's responsibilities. This makes up for the lack of corporate responsibility for financial reporting under Regulation S-K Item 308.[243] For instance, in the preparation and presentation of financial statements, management must provide a written representation that it has fulfilled its responsibility for the preparation and presentation of the financial statements as set out in the terms of the audit engagement and, in particular, whether the financial statements are prepared and presented in accordance with the applicable financial reporting framework.[244] The auditor shall likewise request a written representation that management has provided the auditor with all relevant information agreed in the terms of the audit engagement, and that all transactions have been recorded and are reflected in the financial statements.[245] If management does not provide these two particular representations,[246] or the auditor doubts the integrity of the representations given,[247] the auditor shall disclaim the opinion.

The auditor may also request other written representations about the financial statements. These representations may supplement part of the two required written representations discussed earlier, although they will not form part of it. These matters include (i) whether the selection and application of accounting policies are appropriate, and (ii) whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognized, measured, presented, or disclosed in accordance with that framework: a) plans or intentions that may affect the carrying value or classification of assets and liabilities, b) liabilities, both actual and contingent, c) title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral, and d) aspects of laws, regulations, and contractual

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[241] ¶ 28 at 8.
[242] Philippine Standard on Auditing 260, ¶ A48 at 21.
[243] Internal Control Over Financial Reporting, *supra* note 25.
[244] Philippine Standard on Auditing 580, ¶ 10 at 5.
[245] ¶ 11 at 5.
[246] ¶ 20(b) at 7.
[247] ¶ 20(a) at 7.

agreements that may affect the financial statements, including non-compliance.[248]

In addition, the auditor may request a specific written representation that management has communicated to the auditor all deficiencies in internal control which management is aware of.[249]

As discussed earlier, financial statements are filed as a part of Philippine SEC Form 17-A.[250] Their inclusion greatly makes up for the lack of a similar Regulation S-K Item 308 in Philippine SEC Form 17-A. The lack of a similar Regulation S-K Item 308 in Philippine SEC Form 17-A may have been an oversight on the part of the regulators, because it is clear that management responsibility for financial reporting is an auditing standard. However, it is recommended that Philippine SEC Form 17-A be amended to include such a similar rule so that corporate responsibility for financial reporting is specifically reflected as part of the disclosure itself, and not buried inside the financial statements.

C. Philippine Lawyers: Waiting at the Gates

In the wake of all the corporate misdeeds that stemmed from the Enron scandal, the Philippine Code of Corporate Governance surprisingly did not provide an ethical and governance framework within which lawyers can have more active roles in preventing or dealing with corporate fraud.

What should have been an opportune moment to enact a rule similar to Sarbanes-Oxley Section 307, that would have helped Philippine lawyers to be at par with their American counterparts in the battle against corporate fraud, was completely passed. The 2009 Revised Code of Corporate Governance provided a weak enumeration of the typical day-to-day duties and responsibilities of lawyers. It remained rather myopic in terms of recommending how Philippine lawyers may have enhanced roles in corporate governance reforms post-Enron.

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[248] ¶¶ A12 at 9-11.
[249] ¶ A13 at 11.
[250] Form 17-A, Part 1, Item 7.

The 2002 Code of Corporate Governance

The 2002 Code of Corporate Governance was not sufficiently responsive to the Enron scandal, as it failed to provide a framework of action for Philippine lawyers against corporate fraud. It was rather poorly crafted and only loosely described the duties of a corporate secretary.[251] It did not address any ethical considerations and procedures should any fraud or violations of corporation law or securities law ever occur:

> The Corporate Secretary, who must be a Filipino, is an officer of the corporation. Perfection in performance and no surprises are expected of him. Likewise, his loyalty to the mission, vision and specific business objectives of the corporate entity come with his duties.
>
> Like the CEO, he should work and deal fairly and objectively with all the constituencies of the corporation, namely, the Board, management, stockholders and other stakeholders. As such, he should be someone his colleagues and these constituencies can turn to, trust and confide with on a regular basis.
>
> He should have the administrative skills of the chief administrative officer of the corporation and the interpersonal skills of the chief human resources officer. If the Corporate Secretary is not the general counsel, then he must have the legal skills of a chief legal officer. He must also have the financial and accounting skills of a chief financial officer, and, lastly the vision and decisiveness of the CEO.
>
> Since there are different individuals on top of various corporate activities, the Corporate Secretary should be fully informed and be part of the scheduling process of the different activities. As to agendas, he should have the schedule thereof at least for the current year and should put the Board on notice before every meeting. It is a very important discipline to get the Board to think ahead. He should serve as an adviser to director's responsibilities and obligations.

[251] The provisions relevant to lawyers are those on the corporate secretary. The corporate secretary is usually a lawyer who also serves as general counsel. The term "lawyer" here shall be used interchangeably with corporate secretary, general counsel, and in-house counsel, unless otherwise indicated.

> The Corporate Secretary should make sure that directors have before them everything that they need to make an informed decision. When the Board makes a decision, it is covered by a business judgment that can be arrived at by the members acting in good faith with the assistance of the Corporate Secretary who should review carefully the information presented to the directors at the time they are to make a decision.[252]

In the 2009 Revised Code of Corporate Governance, not much changed in the duties of the corporate secretary:

> The Corporate Secretary, who should be a Filipino citizen, and a resident of the Philippines, is an officer of the corporation. He should –
>
> (i) Be responsible for the safekeeping and preservation of the integrity of the minutes of the meetings of the Board and its committees, as well as the other official records of the corporation;
>
> (ii) Be loyal to the mission, vision and objectives of the corporation;
>
> (iii) Work fairly and objectively with the Board, Management and stockholders;
>
> (iv) Have appropriate administrative and interpersonal skills;
>
> (v) If he is not at the same time the corporation's legal counsel, be aware of the laws, rules and regulations necessary in the performance of his duties and responsibilities;
>
> (vi) Have a working knowledge of the operations of the corporation;
>
> (vii) Inform the members of the Board, in accordance with the by-laws, of the agenda of their meetings and ensure that the members have before them accurate information that will enable them to arrive at intelligent decisions on matters that require their approval;

252 SEC Memorandum Circular No. 2, Series of 2002 *available at* http://www.sec.gov.ph/index.htm?ccg/chapter6to11-ccg (last visited Dec. 4, 2011 4:00 p.m. EDT). This applies to public corporations in the Philippines.

> (viii) Attend all Board meetings, except when justifiable causes, such as, illness, death in the immediate family and serious accidents, prevent him from doing so;
>
> (ix) Ensure that all Board procedures, rules and regulations are strictly followed by the members; and
>
> (x) If he is also the Compliance Officer, perform all the duties and responsibilities of the said officer as provided for in this Code.[253]

On the other hand, the compliance officer[254] is tasked to:

> …report directly to the Chair of the Board. He shall perform the following duties:
>
> (i) Monitor compliance by the corporation with this Code and the rules and regulations of regulatory agencies and, if any violations are found, report the matter to the Board and recommend the imposition of appropriate disciplinary action on the responsible parties and the adoption of measures to prevent a repetition of the violation;
>
> (ii) Appear before the Commission when summoned in relation to compliance with this Code; and
>
> (iii) Issue a certification every January 30th of the year on the extent of the corporation's compliance with this Code for the completed year and, if there are any deviations, explain the reason for such deviation.[255]

While the Revised Code of Corporate Governance may show a semblance of a governance framework in place, such as provisions on the audit committee,[256] nomination committee,[257] compensation or remuneration

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[253] SEC Memorandum Circular No. 6, Series of 2009 *available at* http://www.sec.gov.ph/circulars/cy,2009/sec-memo-06,s2009.pdf (last visited Dec., 2011 4:00 p.m. EDT).

[254] These provisions on the compliance officer appeared only in the 2009 Revised Code of Corporate Governance.

[255] Art. 3(M).

[256] Art.3(K)(i).

[257] Art. 3(K)(ii)(a).

committee,[258] and for the appointment of an external auditor,[259] it has specifically neglected to provide an ethical and governance framework within which the corporate lawyer can advance corporate responsibility.[260] The various provisions mentioned above that pertain to the corporate secretary do not provide constructive guidance for a lawyer to better countenance criminal, fraudulent or deceptive conduct likely to cause harm to the corporation or its shareholders.[261] The Revised Code of Corporate Governance still did not address any measures to prevent future instances of failure of lawyer corporate oversight that led to the various accounting scandals of 2001 and 2002.

The original Code of Corporate Governance was enacted on April 5, 2002, just a few months before the passage of Sarbanes-Oxley on July 30, 2002. The Revised Code of Corporate Governance appeared in 2009. One would think that the Philippine SEC should have at least taken a cue from Sarbanes-Oxley to review and include a similar Section 307 provision into the Revised Code of Corporate Governance. However, this was not the case, and so the supposed role of the Philippine lawyer as a "gatekeeper" in effective corporate governance to this day remains in the backseat of legislation.

Since the Philippines is mainly a civil law system, it can be argued that it should not be that difficult for a law or regulation similar to Sarbanes-Oxley Section 307 to be passed. However, as previously discussed, the 2009 Revised Code of Corporate Governance still failed to include provisions for the reporting of fraud comparable to Section 307. While the duties and responsibilities of the accountant and auditors were expanded, no coextensive improvements were made to govern lawyers' duties to report violations. If the hybrid Philippine legal system paradigm favors legislating laws rather than having judge-made laws, then something seems to be amiss.

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[258] Art. 3(K)(ii)(b).

[259] Art. 5(B).

[260] Preliminary Report of the American Bar Association Task Force on Corporate Responsibility, 58 BUS. LAW. 189 (2002), at 12.

[261] *Id.*, at 25.

The Lack of the Concept of the Organization as the Client in Philippine Legal Ethics

Unfortunately, Philippine lawyers do not benefit from a similar Sarbanes-Oxley Rule 307[262] that would have also made them "gatekeepers" by reporting material violations to the Philippine SEC.

The root of this problem has to do with the Philippine Code of Professional Responsibility ("Philippine CPR").[263] It does not have a similar American Bar Association Model Rule ("ABA Model Rule") 1.13.[264] ABA Model Rule 1.13 on the Organization as Client is the bedrock principle for Sarbanes-Oxley Rule 307.

While the U.S. Congress was deliberating on the passage of Sarbanes-Oxley, the American Bar Association created a Task Force on Corporate Responsibility to provide an ethical and governance framework within which the corporate lawyer can advance corporate responsibility. Specifically, the Task Force was created to:

> examine systemic issues relating to corporate responsibility arising out of…Enron….which have shaken confidence in the effectiveness of the governance and disclosure systems applicable to public companies in the United States. The Task Force will examine the framework of laws and regulations and ethical principles governing the roles of lawyers…[t]he Task Force will allow the ABA to contribute its perspectives to the dialogue now occurring among regulators, legislators, major financial markets and other organizations focusing on legislative and regulatory reform to improve corporate responsibility.[265]

The Task Force acknowledged that in the framework of public corporation governance in the United States,[266] lawyers may find themselves in an "atmosphere of adversity,"[267] recognizing precisely, as previously discussed,

[262] *Supra* note 88.

[263] Philippine Code of Professional Responsibility (1988), *available at* http://www.ibp.ph/d07.html (last visited Nov. 13, 2012 at 2:09 P.M. EDT).

[264] American Bar Association Model Rules of Professional Conduct, Rule 1.13 (2000). This is the Rule on the Organization as Client.

[265] *Supra* note 94, at 2.

[266] *Id.*, at 10.

[267] *Id.*, at 23, as cited in Jardeleza-Eisenberg Paper, at 13.

that "the competition to acquire and keep client business, or the desire to advance within the corporate executive structure, may induce lawyers to seek to please the corporate officials with whom they deal rather than to focus on the long-term interest of their client, the corporation."[268] The Task Force recognized that there should be a continuing effort for the formulation of policies governing lawyers towards the further promotion of corporate responsibility, particularly in light of the passage of Sarbanes-Oxley.[269]

The Task Force believed that:

> [n]evertheless, lawyers for the public corporation must bear in mind that **their responsibility is to the corporation**, and not to the corporate directors, officers or other corporate agents with whom they necessarily communicate in representing the corporation. **This is the bedrock principle recognized in Rule 1.13(a) of the Model Rules. Outside lawyers retained by the corporation and lawyers employed by the corporation both must exercise professional judgment in the interests of the corporate client, independent of the personal interests of the corporation's officers and employees.** Lawyers who provide legal advice to corporate clients most effectively fulfill that duty of independent professional judgment by **gaining an understanding of the client's objectives**, so that they can most readily identify means to achieve those objectives that comply with applicable law. Yet while the depth of understanding of the corporate client depends upon active and close involvement with the corporation's officers, lawyers must at the same time retain the professional detachment that allows them to recognize and point out issues of legal compliance, even at the risk of being perceived as unduly pessimistic or obstructive of the business plans sought by the corporation's executive officers.[270] (Emphasis supplied)

This "bedrock principle" that is also the foundation of Sarbanes-Oxley Rule 307 posits that the lawyer's fiduciary duty is to work towards the best interests of the organization as the client. Without an understanding of the identity of the corporation as the client, a lawyer will not be mindful of his or her duty to "report evidence of a material violation of securities law or a breach of fiduciary duty or similar violation by the company or any agent

[268] *Id.*, at 15, as cited in Jardeleza Eisenberg Paper, at 13.
[269] *Supra* note 264, at 12.
[270] *Supra* note 94, at 23-24, as cited in Jardeleza Eisenberg Paper, at 13.

thereof" as mandated by Rule 307. If the lawyer misapprehends the identity of the corporation as the client, he or she will either fail to detect violations or breaches of fiduciary duty to the corporation, or may even aid or abet these very breaches or violations. While the Task Force acknowledged that Rule 307 was enacted "in response to [the] concern that existing rules of professional conduct did not sufficiently direct the lawyer for the corporation to report illegal conduct to the corporation's board of directors,[271] lawyers are still aided by the principle enshrined under ABA Model Rule 1.13.[272]

The American Bar Association Model Rule 1.13, and the Lack Thereof in the Philippines

ABA Model Rule 1.13 specifically guides American lawyers on their ethical duties towards clients that are juridical entities. ABA Model Rule 1.13(a) provides that "a lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents."[273] This Model Rule does not directly define who or what the organization is as the client. Instead, it explains the identity of the client by way of explaining how it is represented. It indicates that an organization exists as a separate legal entity. This entity acts through constituents which it has duly authorized. These constituents, who are natural persons, are the human vehicles through which the organization acts precisely because the organization is inanimate. The lawyer is thus employed by this inanimate entity that acts through duly authorized constituents who are natural persons. The key word is "represents." While the organization acts through these constituents, ABA Model Rule 1.13(a) provides that the lawyer represents the organization, and not the constituents.[274]

ABA Model Rule 1.13 crystallized what is now known as the entity theory of ethics.[275] An organizational client is a legal entity, but it cannot act

[271] *Supra* note 94, at 7.

[272] Jardeleza-Eisenberg Paper, at 14.

[273] See Annex "A."

[274] Jardeleza PLJ paper, at 114.

[275] *See* Meehan v. Hopps, 301 P.2d 10, 14 (Cal. Dist. Ct. App. 1956) ("The attorney for a corporation represents it, its stockholders and its officers in their representative capacity. He in [no way] represents the officers personally."), *as cited in* Darian Ibrahim, *Solving the Everyday Problem of Client Identity in the Context of Closely Held Businesses,* 56 ALA. L. REV. 181, 187 (2004).

except through its officers, directors, employees, shareholders, and other constituents. To illustrate, a competitor sues a corporate client for an alleged antitrust violation. The corporate lawyer does not represent a shareholder of the defendant corporate client, who is likewise a shareholder of the competitor. The lawyer instead represents the corporation as an entity.[276]

ABA Model Rule 1.13 is the foundation for a two-tiered approach under the American Bar Association's Model Rules of Professional Conduct in solving such ethical problems. First, it provides the guidelines on client identity and representation specifically for the organization as the client. This first level of inquiry involves determining to whom the lawyer owes his or her ethical duties. This preliminary consideration is crucial because of the unique triangular arrangement created in the course of representing this organization as the client. The corporation, as an inanimate independent juridical entity, can act only through its human constituents. The lawyer, therefore, does not theoretically deal directly with the corporation as the client in the traditional sense of a client. He or she manages the corporation's legal affairs by interacting with the human agents who run it.[277]

The overall effect of this triangular arrangement involving the corporation, the lawyer, and the constituents is akin to an "Alice in Wonderland" quality where interests among corporate constituencies diverge:

> The client to which [the lawyer] owes undivided loyalty, fealty and allegiance cannot speak to him except through voices that may have interests adverse to his client. He is hired and may be fired by people who may or may not have interests diametrically opposed to those of his client. And finally, his client is itself an illusion, a fictional "person" that exists or expires at the whim of its shareholders, whom the lawyer does not represent.[278]

The Comment to ABA Model Rule 1.13[279] explains that the authority and responsibility provided in it are concurrent with the authority and responsibility provided in the other Model Rules. In particular, ABA Model Rule 1.13 does not limit or expand the lawyer's responsibility under Rules

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[276] RONALD ROTUNDA, PROFESSIONAL RESPONSIBILITY 337 (year), as cited in JARDELEZA, *supra* note 101, at 115.

[277] Jardeleza PLJ Paper, at 101.

[278] Ralph Jonas, *Who Is The Client? The Corporate Lawyer's Dilemma*, 39 HASTINGS L.J. 617, 619, as cited in Jardeleza PLJ Paper, at 102.

[279] Model Rule 1.13, Comment [6].

1.6,[280] 1.8,[281] 1.16,[282] 3.3,[283] or 4.1.[284] Thus, lawyers should be guided by this two-tiered framework that allows them to be clear as to whom the duties of all these other Model Rules are owed. The clear purpose behind ABA Model Rule 1.13 is thus to enhance the corporate lawyer's ability to represent the best interests of the corporation without automatically having the additional and potentially conflicting burden of representing the corporation's constituents.[285]

ABA Model Rule 1.13 is the foundation and principle for Rule 307. It provides the rationale and support for why Rule 307 was enacted in the first place. It thus serves as the foundation for effective corporate governance measures for the lawyer. In order to actively promote corporate compliance and good governance measures, it is critical that the lawyer understands and keeps in mind that it is the corporation that is the client. From this will flow all the other fiduciary duties of a lawyer such as avoidance of conflicts of interest,[286] confidentiality,[287] among others, just as any other duties owed to a client. The lawyer cannot try to be a beacon against corporate fraud if he or she does not recognize to whom he owes the duties for combating fraud.[288]

There is no similar ABA Model Rule 1.13 in the Philippine CPR. The Philippine CPR still adheres to the traditional notion of a litigious client as a natural person who engages the services of a lawyer for legal advice, or for the purposes of prosecuting or defending a suit in his behalf and usually for a fee.[289] As previously discussed, the lack of a rule similar to ABA Model Rule 1.13 for Philippine legal ethics becomes the tenet for a host of legal ethics problems specifically related to entity representation.

This may possibly explain why no similar Sarbanes-Oxley Rule 307 has been enacted in the Philippines. Philippine legal ethics rules do not currently provide any guidance on how lawyers should deal with clients that are juridical

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[280] Model Rule 1.6 on Confidentiality of Information.

[281] Model Rule 1.8 on Conflict of Interest: Current Clients: Specific Rules.

[282] Model Rule 1.16 on Declining or Terminating Representation.

[283] Model Rule 3.3 on Candor Towards the Tribunal.

[284] Model Rule 4.1 on [Transactions With Persons Other Than Clients]; Truthfulness in Statements to Others.

[285] Jesse v. Danforth, 485 N.W.2d 63 (Wis. 1992) *as cited in* Jardeleza PLJ Paper, at 132.

[286] Model Rules of Professional Conduct, § 1.7.

[287] § 1.6.

[288] Jardeleza-Eisenberg Paper, *supra* note 88, at 14.

[289] ERNESTO PINEDA, LEGAL AND JUDICIAL ETHICS 5 (1999 ed.) *as cited in* Jardeleza PLJ Paper, at 121; Jardeleza-Eisenberg Paper, at 20.

entities. This gaping hole then becomes the cornerstone for a myriad of legal ethics problems that involve entity representation. In the context of a post-Enron, Sarbanes-Oxley world, if a Philippine lawyer does not know that the corporation is his or her client, how is he or she supposed to combat fraud committed against it?

Even if a Rule 307 were to be enacted at this moment in the Philippines, the Philippine CPR will not be able to provide the foundational support for Philippine lawyers in the same way that ABA Model Rule 1.13 does for Rule 307.

Sarbanes-Oxley Section 307 rules cannot just be enacted in the Philippines without amending the Philippine CPR[290] to include a rule that recognizes an organization as a client. In this case, ABA Model Rule 1.13 must be used as a reference point.

Not only is a "client" or an "entity client" left undefined in the Philippine CPR, there is likewise no provision similar to ABA Model Rule 1.13(a) that would even define the term "client" by way of explaining the arrangement involving representation. The definition of a client is only implicitly defined in Philippine jurisprudence.

The nature of a lawyer-client relationship in the Philippines is premised under the Roman law concepts of *locatio conductio operarum* (contract of lease of services), where one person offers his services and another hires him without reference to the purpose for which his services are to be performed. Such services may be compensated by *honorarium* or for hire, and *mandato*, or contract of agency. In this case, a friend on whom reliance could be placed makes a contract in his name, but gives up all of his gain by contract to the person who requested him.[291] The "client" in the Philippine legal profession is thus defined by way of describing the lawyer-client relationship. Given this description, it is evident that there is an emphasis on the client as a natural person.[292]

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290 *Available at* http://www.ibp.ph/d07.html (Last visited Dec. 4, 2011 4:00 p.m. EDT).

291 Regala v. Sandiganbayan, G.R. 108113, 262 SCRA 123, 137-138, Sep. 20, 1996.

292 PINEDA, *supra* note 290.

To illustrate some problems that may be caused by the lack of a similar ABA Model Rule 1.13 in Philippine legal ethics, consider Model Rules 1.13(f) and 1.13(b).

ABA Model Rule 1.13(f)

ABA Model Rule 1.13(f)[293] advises lawyers that

> [i]n dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

This is the "Miranda Warning" provision[294] that allows a lawyer to explain where his loyalties lie in case a constituent has a conflict of interest with the corporation. There are times when the organization's interests may be adverse to those of its constituents. In such circumstances the lawyer should advise any constituent, whose interest is adverse to that of the organization, of the potential conflict of interest which may arise from it; that under such circumstances, the lawyer cannot represent such constituents; and that he or she may wish to obtain independent representation. Care must be taken to ensure that the individual understands that, when there is such adversity of interest, the lawyer for the organization cannot provide legal representation for that constituent individual, and that discussion between the lawyer for the organization and the individual may not be privileged.[295] Whether such a warning should be given by the lawyer for the organization to any constituent individual may turn on the facts of each case.[296]

Whether the lawyer "knows or reasonably knows," he or she should remind the adverse constituent that he or she represents the corporation. ABA Model Rule 1.13(f) thus allows a lawyer to categorically state that in case of competing interests, he or she serves the interests of and is loyal to the corporation as his or her client. This will likewise diminish the tendency of all

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[293] See Annex "A".

[294] T. DACEY, Goulston & Storrs, *available at* http://library.findlaw.com/2003/Oct/31/133126.html as cited in JARDELEZA, *supra* note 101, at 116.

[295] Model Rule 1.13 Comment [10].

[296] Model Rule 1.13 Comment [11].

these competing interests to try to influence the lawyer, since he or she will be clear as to where his or her loyalties should lie.[297]

The closest to an ethical "Miranda Warning" of sorts in Philippine legal ethics that would be comparable to ABA Model Rule 1.13(f) is the Philippine CPR Rule 15.08. It provides that "a lawyer who is engaged in another profession or occupation concurrently with the practice of law shall make clear to his client whether he is acting as a lawyer or in another capacity."[298] This is the conflict of interest rule in the Philippine CPR.

The conflict of interest contemplated under this rule, however, contemplates a conflict of interest between professions, not of clients. Further, since there is no provision on entity clients in the Philippine CPR, this does not consider conflicts between constituencies of an organization.

First, a Philippine lawyer who finds himself or herself similarly situated among adverse interests against the corporation cannot "make clear to his client whether he is acting as a lawyer or in another capacity" under Philippine CPR Rule 15.08 because it would be unclear to him or to her as to who the client is in the first place, absent a similar ABA Model Rule 1.13(a) for guidance. Second, in conflict of interest situations involving various constituencies within the corporation, it will likewise be ambiguous as to which constituency the Philippine lawyer will explain where his or her loyalties lie.[299]

ABA Model Rule 1.13(b)

ABA Model Rule 1.13(b)[300] provides that:

> If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably

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[297] Jardeleza PLJ Paper, at 116-117.
[298] See Annex "B".
[299] JARDELEZA, *supra* note 101, at 124.
[300] See Annex "A".

> necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.

A constituent's interest may become so adverse that the constituent may do something that violates a legal obligation to the corporation. In other cases, this may be a violation of a law itself. Under ABA Model Rule 1.13(b), a lawyer should place the best interests of the corporation over and above that of adverse interests of the corporation's constituents. Whenever necessary, the lawyer should employ an up-the-ladder, exhaustion of remedies approach in dealing with these adverse constituents.[301]

ABA Model Rule 1.13(b) thus affords the lawyer two different levels of action depending on the severity of the contemplated adverse act. First, it exhorts the lawyer to act in favor of what will be reasonably necessary in the best interest of the organization. When the constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province. ABA Model Rule 1.13(b) makes it clear, however, that when the lawyer knows that an organization is likely to be substantially injured by action of an officer or other constituent that violates a legal obligation to the organization or is in violation of a law that might be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization.[302]

ABA Model Rule 1.13(b) also makes it clear that when it is reasonably necessary to enable the organization to address the matter in a timely and appropriate manner, the lawyer must refer to higher authority, including, if warranted by the circumstances, the highest authority that can act on behalf of the organization under applicable law. The organization's highest authority to whom a matter may be referred ordinarily will be the board or any similar governing body. However, applicable law may prescribe that under certain

[301] Jardeleza PLJ Paper, at 118.
[302] Model Rule 1.13 Comment [3].

conditions the highest authority reposes elsewhere, for example, in the independent directors of a corporation.[303]

ABA Model Rule 1.13(b) directs the in-house counsel to climb up the corporate ladder in order to determine what the corporation really "wants." This is, of course, in consideration of ABA Model Rule 1.13(a): that the [corporation] acts *through* its duly authorized constituents.[304] One constituent's adverse interest against the corporation may not necessarily be shared by another constituent. ABA Model Rule 1.13(b) makes it the lawyer's ethical duty to go up the ladder and convince constituents with higher authority to veto or reverse an adverse course of action being contemplated by a lower constituent group.[305] If the matter is of sufficient seriousness and importance or urgency to the organization, referral to higher authority in the organization may be necessary even if the lawyer has not communicated with the constituent. Even in circumstances where a lawyer is not obligated by ABA Model Rule 1.13 to proceed, a lawyer may bring to the attention of an organizational client, including its highest authority, matters that the lawyer reasonably believes to be of sufficient importance to warrant doing so in the best interest of the organization.[306]

The up-the-ladder, exhaustion of remedies approach will prevent any one constituent from exerting pressure over the lawyer to give in to this constituent's demands. This approach allows the lawyer to rely on the power of higher authority to veto, overturn, or reverse any action of a lower-ranked constituent. It further allows for an internal review process by a higher-ranked constituent over the actions of a lower-ranked one. Such a process eventually lessens the pressure on the lawyer to please any one constituent group, because the final decisions on matters shall come from higher constituent authority.[307]

In contrast, the Philippine CPR does not provide for an up-the-ladder rule similar to ABA Model Rule 1.13(b). The closest Philippine CPR rule comparable to ABA Model Rule 1.13(b) is Philippine CPR Rule 19.02.[308] It provides that:

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[303] Model Rule 1.13 Comment [5].

[304] Rotunda, *supra* note 276, at 341.

[305] Jardeleza PLJ Paper, at 119.

[306] Model Rule 1.13 Comment [4].

[307] Jardeleza PLJ Paper, at 121.

[308] Philippine Code of Professional Responsibility, Canon 19, "A Lawyer Shall Represent His Client With Zeal Within The Bounds Of The Law."

> [a] lawyer who has received information that his client has, in the course of the representation, perpetrated a fraud upon a person or tribunal, shall promptly call upon the client to rectify the same, and failing which he shall terminate the relationship with such client in accordance with the Rules of Court.

First, this provision contemplates fraud committed by the client. Without the guidance of a similar ABA Model Rule 1.13, a Philippine lawyer will not be cognizant of a fraud being committed by the corporation as the client. The Philippine lawyer cannot be vigilant against fraud if he or she does not know on whose behalf the lawyer should be vigilant, and against whom it should be vigilant.

For example, the fraudulent activity may have been perpetuated by a corporate officer who may not have been authorized by the corporation in the first place. In the alternative, the fraud may also have been caused by an authorized corporate officer who intended to pursue an interest adverse to the corporation. Aside from the possible lack of vigilance against fraud committed by a corporate officer, there is likewise a danger of imputing the fraudulent acts of a corporate officer against the best interests of the corporation to be acts *of* the corporation itself. This provision does not even exhort the Philippine lawyer to have the corporate officer rectify his or her fraudulent acts against the corporation as the client. In the worst case, it may be used to justify having the corporation, who should be the real client, rectify some fraudulent act mistakenly attributed to it, to its detriment and to the advantage of the corporate officer who actually caused such act.[309]

The Philippine lawyer also cannot filter through the various competing interests to find out which corporate constituent truly represents the corporation without a similar ABA Model Rule 1.13 (a) and (b) in place. Applying ABA Model Rule 1.13(b), the "fraud" contemplated in Philippine CPR Rule 19.02 would be analogous to that committed by a corporate constituent who intends to act or refuses to act on a matter related to his or her representation which may result in a violation of a legal obligation to the corporation, and is likely to result in substantial injury to the corporation.[310]

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[309] Jardeleza-Eisenberg Paper, at 23-24.
[310] *Id.*, at 24.

Philippine CPR Rule 19.02 then proceeds to instruct the lawyer to terminate the lawyer-client relationship should the client fail to rectify the fraudulent act done. There is no up-the-ladder, exhaustion of remedies framework for reporting fraud. This disincentivizes the lawyer from calling upon the client to rectify such fraud in the first place. As previously discussed, the competition to acquire and keep client business, or the desire to advance within the corporate executive structure, may well induce lawyers to seek to please the corporate officials with whom they deal, rather than focus on the long-term interest of their client, the corporation.[311] Without an up-the-ladder approach in cases of inaction by higher corporate officials, a Philippine lawyer will be forced to yield to the first corporate constituent he or she encounters, instead of reporting that corporate constituent to higher authority within the corporation.[312]

A violation of a duty involves, in the first place, an entity, having a duty to that entity, and such duty being subsequently violated. It is thus essential that the entity *to whom* such duty is owed is recognized, for there can be no violation of a duty that is not owed to anyone or anything.

The duties that the lawyers violated during the scandals of 2000 and 2001 were their duties to act in the best interests of the corporation should they know of violations of legal obligations to the corporations, or violations of law that reasonably might be imputed to the corporations, and that will likely result in substantial injury to the corporations, as mandated by ABA Model Rule 1.13(b). In the wake of these scandals, the U.S. Congress deemed it best to further define what these "best interests" are. Sarbanes-Oxley Section 307 finds its underpinnings and builds upon the "bedrock principle" of ABA Model Rule 1.13. Section 307 thus presupposes a clear recognition *to whom* these duties of "best interests" of active reporting of fraud are owed. It also presupposes a system in place for alternative actions in case the reporting shall fall on deaf ears. In a post-Enron corporate governance paradigm, it may thus be difficult for jurisdictions such as the Philippines, where no basic concept of entity clients exists, to combat corporate fraud if it does not know *for whom* it is combatting such fraud.

Sarbanes-Oxley Section 307 was enacted by the U.S. Congress "in response to [the] concern that existing rules of professional conduct did not

311 Report of the American Bar Association Task Force on Corporate Responsibility, *supra* note 94, at 15.

312 Jardeleza-Eisenberg Paper, at 24.

sufficiently direct the lawyer for the corporation to report illegal conduct to the corporation's board of directors."[313] The critical element in the enactment of Rule 307 is that there is already a presumption, as supported by ABA Model Rule 1.13(a), that the corporation is the client in whose interest the reports of material violations or breaches of fiduciary duties should be made. The Part 205 regulations likewise elucidate that—

> [a]n attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties **to the issuer as an organization.** That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer **does not make such individuals the attorney's clients.**[314] (Emphasis supplied)

Rule 307 was enacted in order to mandate a specific proactive duty to report fraudulent activities beyond the self-regulating concept of "best interests" under Model Rule 1.13(b). As previously discussed, a particular duty cannot be exercised if the lawyer does know *to whom* he or she owes such duty. *In whose* "best interest" is the lawyer supposed to be vigilant about reporting material violations or breaches of fiduciary duty?

The Importance of Having Outside Counsel

To illustrate how this lack of the concept of the organization as a client may affect Philippine lawyers, consider the chain of events that may affect a Philippine general counsel and the outside lawyers that he or she has hired on a retainer basis.

That same specter of the "competition to acquire and keep client business" that "may induce…to seek to please the corporate officials"[315] hangs over the head of an outside lawyer as well. The Task Force commented that "outside lawyers retained by the corporation…must exercise professional judgment in the interests of the corporate client, independent of the personal

[313] Report of the American Bar Association Task Force on Corporate Responsibility, *supra* note 94, at 10.

[314] *Supra* note 17, § 205.3.

[315] *Supra* note 94, at 15.

interests of the corporation's officers and employees."[316] In addition, the Task Force recognizes that there are

> frequently significant practical obstacles…to outside counsel bringing such misconduct to the attention of appropriate corporate authorities. In many situations operational personnel will hire (or be perceived as hiring) outside counsel and be responsible for future hires of counsel. Consequently, outside counsel may be discouraged from fulfilling the professional responsibility to the corporation out of concern over offending the personal desires or interests of the employee or department which retains counsel. The outside counsel must nevertheless comply with applicable rules of professional conduct.[317]

In fact, the Task Force recommends that "each retention of outside counsel to the corporation should establish two things at the outset of the engagement… [one of which is] (2) the understanding that outside counsel are obliged to apprise the general counsel, through that direct line of communication, of material violations or potential violations of law by the corporation or of material violations or potential violations of duties to the corporation."[318] This is also contemplated under the Part 205 regulations, that if an attorney becomes aware of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer. If such attorney does not reasonably believe that the chief legal officer has made an appropriate response to the report, the attorney is required to report to the audit committee, to another committee consisting of directors not employed by the corporation, and to the board.[319]

In a hypothetical situation where a material violation has occurred and is required to be reported under Section 307, the two supposed levels of Philippine "gatekeepers" may only end up dangerously opening the floodgates further to unleash the fraud. First, both the general counsel and the outside counsel, without foundational support from a similar ABA Model Rule 1.13(a), will be unclear as to the identity of the corporation as their client. Because of this, their vigilance in reporting will be impaired. They may easily give in to the adverse interests of the board and/or corporate officers in exchange for job

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[316] *Id.,* at 23.
[317] *Id.*, at 39-40.
[318] *Id.*, at 36.
[319] *Supra* note 17, §§205 3(b)(1-4).

security, career advancement, and the like. If they are unclear about the corporation as their client, then they will likewise be unclear about whether they even have the duty to report.

Having outside counsel should at least provide a fallback or extra layer of legal vigilance to report violations. However, if the outside counsel himself or herself also lacks the proper guidance in terms of client identity under ABA Model Rule 1.13(a), he or she may be ineffective in performing this duty.

In the case of outside counsel, the Task Force surmises that

> outside counsel who knows of facts from which such counsel concludes that a duty to the corporation is being or has been breached or that the corporation may be violating or potentially violating the law is unlikely to have access to the corporation's resources that would permit an appropriate investigation to be made. In such a circumstance, Model Rule 1.13 or the Part 205 Rules may require the outside counsel to communicate with higher corporate authorities…[320]

This, of course, presupposes that the outside counsel is cognizant of the corporation as the client. The outside counsel may not only seek to please the board and/or corporate officers in the same way that the general counsel may be tempted to do so, but may find himself or herself beholden to the general counsel for keeping him or her on retainer.

Clearly, this will not bode well for the corporation which expects the undivided loyalties of its "gatekeepers." Whether from within the corporation (*i.e.,* the general counsel having overall supervision of the corporation's legal affairs) or outside the corporation (*i.e.,* outside counsel as support for the general counsel), the corporation will not be able to rely upon its "gatekeepers" to actively report fraud or violations.

D. Philippine Employees: Away from the Gates

There is no law similar to Sarbanes-Oxley Section 806,[321] which provides statutory protection for similarly situated Filipino employees of public

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[320] *Supra* note 94, at 39.

[321] Sarbanes-Oxley § 806, as amended by Dodd-Frank §9 29A.

corporations, their subsidiaries, and affiliates. Filipino employees are on their own to whistleblow within the corporation at their own risk. Philippine corporations are of course free to voluntarily enact internal whistleblowing programs as part of corporate governance best practices, but there is no actual legislation on this matter. The general whistleblower protection law, as earlier discussed, is still pending in the Philippine Congress.[322]

E. The Philippine Stock Exchange: Recommendatory Gatekeeping Only

The Philippine Stock Exchange issued "The Corporate Governance Guidelines for Companies Listed on the Philippine Stock Exchange" (the "PSE Guidelines") on November 26, 2010 for all listed Filipino corporations. The PSE Guidelines present the corporate governance measures and practices that it requires of all listed corporations. However, it should be noted that the PSE Guidelines specifically state that these guidelines are merely recommendatory and are not prescriptive. They are interpretations of the Philippine Stock Exchange as to the corporate governance principles that should govern listed corporations. These guidelines do not have the force and effect of law, rules or regulations.[323]

The Philippine Revised Code of Corporate Governance however, fills in the administrative gap for penalizing violations of corporate governance practices. It prescribes a fine of not more than Php200,000 (or about US$4,500) for every year that a covered corporation, *i.e.,* public and/or listed corporation, violates any of its provisions. This is without prejudice to separate fines or penalties for violations of the Philippine Securities Regulation Code.[324]

The PSE Guidelines recommend that corporations should have efficient internal audit and control systems that assure the effectiveness and efficiency of operations, reliability of financial reporting, measures for deterrence and investigation of fraud, proper safeguarding of assets, and

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[322] Whistleblower Protection Act of 2011, S. No. 2860, 15th Congress, *supra* note 9.

[323] The Corporate Governance Guidelines for Companies Listed on the Philippine Stock Exchange, 5, *available at* http://www.pse.com.ph/stockMarket/listedCompaniesRules.html?tab=0. (last visited Nov. 15, 2012 at 3:16 A.M. EDT).

[324] Revised Code of Corporate Governance, Art. 11.

compliance with laws and regulations. The PSE Guidelines particularly recommend that the internal audit function should be a separate unit in the corporation that the board oversees.[325] The corporation should have a comprehensive enterprise-wide compliance program that is reviewed annually.[326] The internal audit function must have an institutionalized quality service program.[327] The PSE Guidelines recommend a mechanism that allows employees, suppliers, and other stakeholders to raise valid issues.[328] Finally, the CEO and the Chief Audit Executive should attest in writing, at least annually, that a sound internal audit, control and compliance system is in place and working effectively.[329]

The last two mentioned guidelines are worthy of note. While the Philippine Stock Exchange does recommend some sort of reporting mechanism "to raise valid issues" most probably akin to a whistleblowing program, it itself does not have a formal whistleblowing program compared to the NYSE Euronext and NASDAQ OMX. It was recently reported, however, that a new Capital Markets Integrity Corporation ("CMIC") was created as an independent unit of the Philippine Stock Exchange. It boasts of new state-of-the-art computer facilities that can detect suspected cases of market manipulation and insider trading.[330] The CMIC refers these cases to the newly created Investor Protection and Surveillance Department ("IPSD") of the Philippine SEC. The IPSD then acts on anonymous tips and referrals from the CMIC.[331] The CMIC and IPSD do not, however, appear to be formal external whistleblower programs in and of themselves. They focus more on surveillance, prosecution, and enforcement without a formal awards program and anti-retaliation protections.

As to the last mentioned guideline, the Philippine Stock Exchange specifically recommends that financial reports be attested to by the CEO and

[325] Corporate Governance Guidelines for Companies Listed on the Philippine Stock Exchange, ¶ 3.1.

[326] ¶ 3.2.

[327] ¶ 3.3.

[328] ¶ 3.4.

[329] ¶3.5.

[330] *The Sooner The Better,* PHIL. DAILY INQUIRER, *available at* http://opinion.inquirer.net/38842/the-sooner-the-better (last visited Nov. 13, 2012 at 3:59 A.M. EDT).

[331] *SEC Probes 6 Cases of Stock Market Manipulation,* PHIL. DAILY INQUIRER, *available at* http://business.inquirer.net/86404/sec-probes-6-cases-of-stock-market-manipulation-3-insider-trading-cases (last visited Nov.13, 2012 at 5:01 A.M. EDT).

the CFO.[332] As discussed earlier, while this is not specifically required under Philippine SEC Form 17-A,[333] it is required by Philippine auditing standards.[334] While merely recommendatory on the part of the Philippine Stock Exchange as part of the PSE Guidelines, it does serve as a clear reminder of corporate responsibility for financial reporting.

F. The Philippine SEC: No Formal Whistleblower Program

The Philippine SEC does not have a formal whistleblower program similar to that of the U.S. SEC's Office of the Whistleblower. It does have a Public Information and Assistance Hotline[335] where the general public may report anonymous tips of fraudulent securities practices. As discussed earlier, the Philippine SEC has a newly created division called the IPSD. The IPSD, however, is more of a surveillance, prosecution, and enforcement division of the Philippine SEC.

As discussed thus far, Sarbanes-Oxley, Dodd-Frank, and the U.S. SEC regulations have ensured that U.S. corporations comply with strong, adequate, and sufficient internal control mechanisms for their risk management, reporting, and disclosure compliance systems. In addition, these laws and regulations secure protections for the "gatekeepers" who perform these internal control functions by providing them with up-the-ladder internal whistleblowing frameworks. The U.S. SEC whistleblower program can be seen as a supplementary measure when some gatekeeping falls through the cracks.

In contrast, Philippine auditors are "lonely heroes" as the single properly active gatekeepers in the Philippines. Because the Philippine auditing standards are compliant with international standards, they benefit from the protections afforded to their Western counterparts in terms of reporting fraud in the preparation of financial reports. There is thus a need for a formal external whistleblowing program in the Philippines since only one out of the three "gatekeepers" are empowered in the Philippines. An external

[332] Corporate Governance Guidelines for Companies Listed on the Philippine Stock Exchange, ¶ 5.7.

[333] Philippine SEC Form 17-A.

[334] Philippine Standard on Auditing 580, Written Representations..

[335] *Available at* http://www.sec.gov.ph/aboutsec/locationanddirectory.html (last visited Nov.14, 2012 at 9:34 P.M. EDT).

whistleblowing program managed by the Philippine SEC can account for these gaps in legislation.

PART III: FACTORS TO CONSIDER IN IMPLEMENTING A PHILIPPINE EXTERNAL WHISTLEBLOWING PROGRAM

Before the Philippine government decides to replicate the U.S. SEC Office of the Whistleblower, it should examine possible factors that may hinder its implementation.

Possibly the greatest obstacle to a proposed external whistleblower program is the lack of a whistleblowing culture in the Philippines itself. As with other Asian countries, it ascribes to the culture of group harmony and relationships. This is in contrast to the norm of individualism in Western countries. Unfortunately, this culture precisely fosters and encourages fraudulent practices to go unreported. An individual would rather protect his or her relations with others rather than blow the whistle on them.

This is in addition to the high rate of corruption in the Philippines.[336] On a scale of 0 (highly corrupt) to 10 (very clean), the Philippines scored 2.6 and ranked 129th out of 183 countries in Transparency International's Corruption Perceptions Index 2011. Corruption and the culture of protection of the group do not bode well for the reporting of fraud.

Such aforementioned culture extends to the structure of capital markets in the Philippines.[337] In the Philippines, the industrial elite comprises wealthy families that have preserved their businesses over several generations. Most of these families have become the controlling shareholders of the largest family-based corporations in the Philippines.[338] The pyramid structure of a holding corporation is typical in the Philippines. The largest shareholders are

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[336] *Available at* http://cpi.transparency.org/cpi2011/results/ (last visited Nov.14, 2012 at 11:02 P.M. EDT).

[337] This portion on the Philippine ownership structure was previously discussed in a paper submitted for Corporation in Modern Society seminar under Professors Harvey Goldschmid and Ira Millstein at Columbia Law School, Spring Semester 2012, entitled "The Case For Pockets Of Shareholder Activism: Shareholder Proposals In The Philippines, at 9.

[338] *Available at* http://www.asria.org/publications/lib/country/philippines.pdf> (last visited Apr. 26, 2012 at 9:00 p.m.) *supra* note 340 at 9.

usually members of wealthy families who hold dominant shareholdings within various webs of closely related family corporations. The general public is not a significant investor in the stock market.[339]

The publicly listed companies sector overall shows a similar degree of ownership concentration. On the average, the largest single shareholder owns 41% of outstanding shares. The largest five shareholders own 65% and the top twenty shareholders own 76% of outstanding shares. The presence of pyramid structures is common in family holding companies.[340] With this kind of structure, and in the absence of a general whistleblower law in the Philippines,[341] there is no incentive for a potential whistleblower to report against any fraud that may occur within these webs of corporations held by wealthy family owners.

There is an Office of the Ombudsman, an independent government body created by the 1987 Philippine Constitution,[342] where the general public can file complaints against officers or employees of the government, its subdivisions, agencies or instrumentalities, including government-owned or controlled corporations for illegal, unjust, improper or inefficient acts.[343] Those who have information or personal knowledge, and who have testified, are testifying, or are willing to testify, may seek protection and assistance from the Witness Protection, Security and Benefit Program[344] of the Philippine Department of Justice.

However, it should be noted that the Office of the Ombudsman whistleblowing mechanism is limited to the reporting of government officials. These do not cover private persons, unless they are acting in conspiracy with the government official.[345]

As discussed earlier, the concept of whistleblowing as a whole is so novel in the Philippines that the Whistleblower Protection, Security and

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339 *Available at* http://www.worldbank.org/ifa/rosc_cg_phl_07.pdf (last visited Apr. 25, 2012 at 4:30 a.m. EDT) s*upra* note 340 at 9.

340 *Available at* http://www.asria.org/publications/lib/country/philippines.pdf (last visited Apr. 26, 2012 at 5:00 a.m. EDT) *supra* note 340 at 9.

341 *Supra* note 9.

342 CONST. , art. XI, § 5.

343 CONST., art. XI, § 13(1).

344 Rep. Act. No. 6981 (1991).

345 Rules Implementing The Code Of Conduct And Ethical Standards For Public Officials And Employees, Republic Act No. 6713 (1989), Rule XI, §1.

Benefit Act of 2011[346] is still pending in the Philippine Senate. This would have been the very first comprehensive general whistleblowing law in the Philippines. Contrast this to the U.S. False Claims Act of 1863.[347] The U.S. already had some idea of the concept of whistleblowing some 140 years or so earlier.

Another possible difficulty might be the administrative burden of a whistleblowing program. It was recently reported by the Wall Street Journal that the U.S. SEC's Office of the Whistleblower receives an average of eight tips a day, with a total of 2,820 tips as of August 8, 2012. These tips were received from various places in the U.S. and 45 other countries. Critics of the program complain that the Office of the Whistleblower would not have the personnel or the expertise to handle an incoming flood of poor-quality complaints.[348] While the U.S. SEC may be understaffed and cash-strapped for resources like any other government agency, it should be noted that this is a government agency in a developed country.

In contrast, the Philippine SEC is a government agency in an emerging market. Its disclosure filing system is not even computerized. It may encounter a deluge of tips and complaints far greater than the U.S. SEC's Office of the Whistleblower precisely because the Filipino gatekeepers are incapacitated, save for the auditors. The potential Philippine SEC whistleblowing program will have to stand in for the lack of internal whistleblowing mechanisms in Philippine corporations. This might pose a very heavy burden on the Philippine SEC's resources.

PART IV: RECOMMENDATIONS

A. Gatekeeping Legislation and Updating the Philippine CPR

The American Bar Association Task Force on Corporate Responsibility recognized that "the key provision, in [the] current [Model] Rule 1.13(b), is that the lawyer must take appropriate action in the best interest of the client, namely the corporation. While this obligation is a mandate, the [Model] Rule cannot and does not prescribe what action is appropriate; the

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[346] Whistleblower Protection, Security and Benefit Act of 2011, *supra* note 9.

[347] 31 U.S.C. §§ 3729-3733 (1863).

[348] *Available at* http://blogs.wsj.com/corruption-currents/2012/10/18/sec-whistleblower-office-gets-nearly-3000-tips/ (Last visited Nov. 15, 2012 at 4:07 A.M. EDT).

lawyer is obligated to exercise informed professional judgment in determining what steps are 'reasonably necessary in the best interest of the organization.'"[349]

Sarbanes-Oxley Section 307 transformed these "steps" from self-regulating ethical duties to federal duties. These "steps," in the context of corporate governance post-Enron, entail the vigilant and active reporting of material violations of securities laws, breaches of fiduciary duties, and any similar violations whether committed by the corporation itself or by its agents.

An ethical duty, whether judge-made or statutory, is only effective when the identity of the entity *to whom* the duty is owed is clear. As ethical rules are not static and may change over time, whether through model codes, state laws, or federal laws, the fundamental principles behind such duties become all the more crucial and significant to remember.

It is clear as demonstrated from the enactment of Sarbanes-Oxley Section 307 that lawyers should be reminded of the fundamental principle of the corporation as the client. If any future ethical "missteps" should occur that Sarbanes-Oxley might not address, in case of doubt, U.S. lawyers can seek guidance under ABA Model Rules 1.13 and be reminded of to whom their duties should lie.

It is therefore recommended that the Philippine CPR be updated to include a similar ABA Model Rule 1.13 that tackles the organization as the client. If the Philippines intends to become an active participant in good corporate governance measures in line with the rest of the post-Enron world, it should start to seriously consider that it is possible to have an organization as a client to whom ethical duties may be owed. Loose exhortations such as "[b]e loyal to the mission, vision and objectives of the corporation"[350] in the Revised Code of Corporate Governance will not be effective unless a strong foundation of client identity is first in place under Philippine legal ethical rules.

[349] *Supra* note 94, at 41.
[350] At n.257, Article 3 (L)(ii).

B. An External Whistleblowing Program and a Strong Internal Control System

Because the U.S. SEC's whistleblower program has been implemented only very recently, there is not much information or data about it. However, there are some scholarly debates in the U.S. that thresh out its advantages and disadvantages.

The most compelling discussion involves the external whistleblower program's effect on the internal reporting system of corporations and its gatekeepers. As an external reporting mechanism, the U.S. SEC whistleblower program may potentially undermine the internal reporting system of corporations. It may frustrate the primary policy aims of Sarbanes-Oxley to create internal regulatory and control frameworks that encourage sound internal corporate governance systems. These internal governance systems were meant to identify and remedy violations internally.[351]

An external whistleblowing mechanism may particularly impair those who have gatekeeping duties. The gatekeeper loses his or her ability to be an effective "watchdog" when the information about the fraud is relayed externally.[352] Gatekeepers will be unable to detect fraud, and will be more likely to make poor decisions when investing their reputational capital.[353] Since they will not be able to handle external information, this may also create informational asymmetries as to the fraudulent activity.[354] This, in turn, will eventually erode a gatekeeper's credibility. In a possible extreme scenario, the gatekeepers will switch gears and acquiesce to the fraudulent activity if only to retain clients since they will be competing with those who report externally.[355] This may eventually spell the demise of the so-called "gatekeepers."

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[351] Recent Legislation, *Dodd-Frank Act,* 124 HARV. L. REV. 1829, 1829-30 (2011) as cited in Megan Foscaldi, *Whistleblower Provisions of the Dodd-Frank Act*, 31 REV. BANKING & FIN. L. 486, 491 (2012)

[352] Merritt Fox, *Gatekeeper Failures: Why Important, What to Do*, 106 MICH. L. REV.1089 1 (2008), as cited in Emerich Gutter, *Whistleblowers Under The Dodd-Frank Act And Their Impact On Gatekeepers*, 30 REV. BANKING & FIN. L. 753, 779(2011),.

[353] Coffee, *supra* note 11, at 7; Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 54 (1986) at 54, as cited in Gutter, *supra* note 286, at 779.

[354] Coffee, *supra* note 13, at 6 to 7, as cited in Gutter, *supra* note 353, at 779.

[355] Coffee, *supra* note 13, at 62 to 64, as cited in Gutter, *supra* note 353, at 779.

By having a strong and effective internal controls and reporting program, a corporation will be able to prevent, deter, and detect violations before resorting to external whistleblowing programs. However, even the most responsible corporations will not always be able to prevent or deter all fraudulent activity. To prevent further government enforcement action initiated by external whistleblower reporting, corporations must therefore continually review their internal control systems. An external whistleblowing program may thus even incentivize corporations to continually scrutinize their internal control and reporting systems.[356] This may prove costly to corporations, but at least they will pay better attention to their internal control systems and to their corporate governance practices in general.[357]

These are, of course, U.S. dilemmas that already presume proper, sufficient, and competent corporate internal controls systems in place. Unfortunately, the Philippines does not "enjoy" this kind of ambivalence towards implementing a potential external whistleblowing program. The internal controls and reporting systems of Philippine corporations are weak and deficient. Its gatekeepers, save for the auditors, are incapacitated. Until such time that similar legislation such as Sarbanes-Oxley Sections 302,[358] 307,[359] and 806[360] are enacted in the Philippines, it may need an external whistleblower program under the auspices of the Philippine SEC as a stopgap measure.

C. Corporate Governance-Related Reforms

The collectivist Asian culture and the structure of family-owned webs of holding corporations are factors that are deeply entrenched in the Philippines. These may take many years to reform. What the Philippines can currently work on is its legislation, particularly rules and regulations that would improve corporate governance in the country.

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[356] John Ashcroft, Catherine Hanaway, & Claudia L. Oñate Greim, *Whistleblowers Cash In, Unwary Corporations Pay*, 40 HOFSTRA L. REV. 367, 396(2011).

[357] Rebecca M. Katz and David Harrison Katz, *The Dodd-Frank Act: New Life For Whistleblowers And The SEC,* 7 NO. 8 SEC. LITIG. REP. 22 3-4 (2010).

[358] Corporate Responsibility for Financial Reports.

[359] Rules of Professional Responsibility for Attorneys.

[360] Protection for Employees of Publicly Traded Companies Who Provide Evidence of Fraud.

In terms of corporate governance, the Philippines, unlike its U.S. counterpart, is only in its stages of infancy.[361] In 2010, the Philippines was ranked as the lowest in the Asian Corporate Governance Association market survey of 11 Asian countries in terms of corporate governance.[362] This survey had five categories: CG [Corporate Governance] Rules and Practices, Enforcement, Political and Regulatory Environment, International Financial Reporting Standards, and CG Culture. The Philippines scored the lowest in the categories of CG Rules and Practices, Enforcement, and CG Culture.[363]

The Philippines had only started to initiate corporate governance-related reforms in the last decade or so. A new Securities Regulation Code[364] was passed by the Philippine Congress in 2000 to supersede the former Revised Securities Act of 1982. Some of the more salient amendments strengthened the prosecution and enforcement powers of the Philippine SEC, expanded the scope of rules on insider trading and market manipulation, increased the protection of minority investors by institutionalizing rules on mandatory tender offers, and further delegated regulatory powers to self-regulatory organizations.[365]

In 2002, the Philippine SEC issued Memorandum Circular No. 2 that created a "Code of Corporate Governance" to be observed by public or listed corporations. These corporations are mandated to submit a Manual of Corporate Governance to embody the ideals and principles of Western corporate governance measures following the enactment of Sarbanes-Oxley Act. Corporations are required to complete annual self-rating forms[366] to assess their compliance with this Code of Corporate Governance and their own Manuals of Corporate Governance.[367] Compliance with these self-rating forms and Manuals of Corporate Governance are under pain of administrative

[361] *Supra* note 340, at 12.

[362] *Supra* note 340, 10, *available at* http://www.businessmirror.com.ph/home/banking-a-finance/7000-philippines-lowest-in-corporate-governance-survey (last visited Apr. 24, 2012 at 3:30 P.M. EST)

[363] *Id.*.

[364] Rep. Act. No. 8799 (2000). This is the Securities Regulation Code.

[365] *Supra* note 340, 11, *available at* http://www.worldbank.org/ifa/rosc_cg_phl_07.pdf (last visited Apr. 26, 2012 at 3:30 P.M. EST) *supra* note 273, at 11.

[366] Corporate Governance Scorecard, *available at* www.sec.gov.ph (last visited Apr. 26, 2012 at 4:00 P.M. EST).

[367] *Supra* note 340, *available at* http://www.worldbank.org/ifa/rosc_cg_phl_07.pdf;www.sec.gov.ph. (last visited Apr. 26, 2012 at 4:00 P.M. EST) .

penalties such as fines.[368] In 2009, the Philippine SEC issued a Revised Code of Corporate Governance to update and amend the previous one issued in 2002.[369]

In fact, there is a Philippine Senate bill entitled "Corporate Reform Act of 2004,"[370] which is patterned largely after Sarbanes-Oxley.[371] However, this bill has been pending congressional review since 2004.

Several institutions and advocacy groups have emerged in recent years to promote good governance practices in the Philippines, such as the Institute of Corporate Directors,[372] the Corporate Governance Institute of the Philippines,[373] and the Asian Institute of Management-Hills Governance Center.[374] These groups offer orientation and training sessions for directors and management that the Philippine SEC and the *Bangko Sentral ng Pilipinas* (Central Bank of the Philippines, or "BSP") have required as prerequisites for appointment for directorship.[375]

There are thus efforts to promote corporate governance best practices in the Philippines. However, the root of the problem is deficient gatekeeping legislation. The Philippine auditors are burdened with the gatekeeping function without the support of the lawyers and the employees. There is thus only one proper and fully functional internal whistleblowing system for Philippine corporations. This, of course, cannot be expected to catch and detect all fraudulent activity within the corporation.

An external whistleblowing program in the Philippines cannot undermine the internal controls and reporting systems of corporations precisely because these systems are deficient. If there is concern about

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368 Revised Code of Corporate Governance, *supra* note 186.

369 *Supra* note 186.

370 S. No. 209, 13th Cong. (2004).

371 *Supra* note 58.

372 *Available at*http://www.icdcenter.org/cg/ (last visited Nov. 17, 2012 at 10:16 P.M. EDT).

373*Available at* http://www.picpa.com.ph/CPE/Accredited-CPE-Providers/Corporate-Governance-Institute-of-the-Philippines.aspx (last visited Nov. 17, 2012 at 10:17 P.M. EDT).

374 *Available at* http://www.aim-hills.ph/ (last visited Nov. 17, 2012 at 10:19 P.M. EDT).

375 *Supra* note 340, 12, *available at* http://www.worldbank.org/ifa/rosc_cg_phl_07.pdf (last visited April 26, 2012 at 3:30 P.M. EST.) *supra* note 340, at 12.

undermining the auditing system as the sole gatekeeping function, then this would only pertain to the auditing aspect of the internal controls of a corporation. A plethora of other possible fraudulent activities elsewhere will still remain unreported. These could have been detected and reported by the lawyers and/or employees if Philippine laws empowered them to do so. Therefore, an external whistleblowing program under the supervision of the Philippine SEC can only help to augment and cover for these gatekeeping functions that are currently absent.

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ANNEX "A"
Model Rule 1.13 Organization As Client

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.

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(f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

<u>ANNEX "B"</u>
Philippine Code of Professional Responsibility

Rule 15.08

A lawyer who is engaged in another profession or occupation concurrently with the practice of law shall make clear to his client whether he is acting as a lawyer or in another capacity.

Rule 19.02

A lawyer who has received information that his client has, in the course of the representation, perpetrated a fraud upon a person or tribunal, shall promptly call upon the client to rectify the same, and failing which he shall terminate the relationship with such client in accordance with the Rules of Court.