

The New Concept of “Undersight” in Securities Regulation

by Daniel P. Westman*

The concept of “oversight” has been familiar to Wall Street lawyers since the passage of the Securities Exchange Act of 1934, which created the Securities and Exchange Commission to police the securities markets. “Gatekeepers,” such as public accounting firms and law firms, also have been viewed as having a role in overseeing the reporting of corporate financial data to ensure its accuracy. And, of course, corporate Boards of Directors have been responsible for overseeing the operations of their corporations, including ensuring the accuracy of financial reports.

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Oversight, however, did not prevent the frauds of recent years at companies such as Enron, WorldCom, Global Crossing, Adelphia, and others. These events have shown how difficult it can be for corporate outsiders like the SEC, accounting and law firms, and Boards of Directors to peer into the inner workings of corporations to determine whether financial fraud is occurring. Obviously, outsiders must rely on others to supply information about corporate financial reports, and that information may be misleading. The solution may be to ensure that individuals at the operational level who understand and are intimately involved in a company’s business have the ability to inform outsiders when they see financial fraud.

“Undersight” is a term I have coined to describe the concept of internal monitoring from the bottom up, which is protected by the employee whistleblower provisions of the Sarbanes-Oxley Act of 2002. These provisions are a significant departure from the prior pattern of whistleblower protection laws. Now, corporate

insiders who see the daily operations of companies are protected by Sarbanes-Oxley if they report concerns about financial fraud. In addition to strengthening “oversight” by creating the Public Company Accounting Oversight Board and mandating other actions, Sarbanes-Oxley also added new “undersight” provisions to protect corporate insiders who witness fraud first hand.

Securities lawyers should familiarize themselves with the “undersight” provisions of Sarbanes-Oxley —not only for the benefit of their clients, but also so they understand the new whistleblowing obligations the statute imposes on attorneys.

“Undersight” is a Significant Change in Legal Protections for Employees

The whistleblower provisions of Sarbanes-Oxley are a significant departure from previous federal and state whistleblower protections. Until Sarbanes-Oxley, most federal and state whistleblower laws applicable to the private sector protected only employees who raised concerns about issues affecting public health or safety. Most such laws did not protect private sector employees who raised concerns about fraud against shareholders because that was not considered a “public” matter.

In contrast, most federal and state laws protecting government sector whistleblowers did protect government employees who raised concerns about waste of funds. The public interest in financial abuse in the government sector has always been clear because such abuse involves taxpayers’ money.

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Until Sarbanes-Oxley, financial fraud in the private sector was viewed as a concern of shareholders only. With the spectacular failures of several major businesses, and the corresponding investment losses suffered by millions of employees and shareholders, Congress decreed in Sarbanes-Oxley that fraud against shareholders is an issue of public concern justifying significant new civil and criminal protections for private sector employees who raise concerns about financial fraud.

Sarbanes-Oxley departs from the prior pattern of whistleblower protection in numerous respects. For the first time, Sarbanes-Oxley creates a civil remedy for whistleblowers in the private sector who raise concerns about financial matters that implicate violations of federal securities laws. Thus, the subject matter of protected disclosures has been significantly broadened beyond the categories of public health and safety.

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In addition, the penalties for retaliation against whistleblowing have been greatly strengthened. The civil provisions of Sarbanes-Oxley allow for immediate reinstatement of whistleblowing employees —even before an evidentiary hearing on the merits —which is an unusual form of relief. Even more dramatically, Sarbanes-Oxley creates severe criminal penalties (including fines and up to 10 years in prison) for retaliation against whistleblowers who raise concerns about violation of *any* federal criminal statute—not simply laws addressing financial fraud. These criminal penalties may apply to *any* employer, regardless whether the employer is publicly traded or privately held, and may apply to individual managers as well as to corporate employers. Criminal sanctions for retaliation against whistleblowers were extremely rare prior to Sarbanes-Oxley.

Moreover, Sarbanes-Oxley uses whistleblower protection as a key component of enforcement of federal securities laws. By 2002, the collapses of several large publicly traded companies appeared to demonstrate that the

system of oversight created by the Exchange Act had failed to prevent massive financial fraud. During 2001 and 2002, numerous individuals testified before Congress about the reasons for the Enron and WorldCom corporate collapses. The Report of the Senate Judiciary Committee on the bill that became Sarbanes-Oxley states: “In a variety of instances when corporate employees at both Enron and Andersen attempted to report or ‘blow the whistle’ on fraud, but (sic) they were discouraged at nearly every turn.”¹

Woven throughout Sarbanes-Oxley is the theme that protection of employees who report financial abuse may help to prevent future corporate collapses and securities frauds. Protection for employees engaging in “undersight” is reflected in many facets of the statute.

- Section 301 requires corporate Audit Committees to create mechanisms for receiving anonymous employee concerns about financial improprieties.
- Section 806 creates new civil protection for employees who report concerns about alleged fraud upon shareholders, and Section 1107 creates new criminal penalties for retaliation that are even broader than Section 806.
- Section 307 requires the SEC to issue regulations setting forth minimum standards of practice for attorneys who practice before the SEC. The SEC rules require attorneys who are aware of financial fraud by their clients to blow the whistle by alerting the issuers’ executive management, and then the issuers’ Boards of Directors if executive management does not respond appropriately.²
- Section 501 requires the SEC to promulgate rules that prohibit brokerage firms from retaliating against securities analysts because of an “unfavorable research report that may adversely affect the present or prospective investment banking relationship of the broker or dealer with the issuer that is the subject of the research report.” This new legal protection for securities analysts was driven by concerns that brokerage firms were pressuring analysts to write overly favorable evaluations of stocks in order to obtain additional investment banking business.

- Section 406 requires issuers of publicly traded securities to disclose whether they have codes of ethics applicable to senior financial officers. Both the New York Stock Exchange and the National Association of Securities Dealers have gone further by requiring listed companies to implement codes of ethics not limited to executive management, and to include in such codes provisions that protect employees who report alleged violations from retaliation. ³

Summary of Civil and Criminal Protections Under Sarbanes-Oxley

Civil action protecting employees of publicly traded employers and of contractors

Section 806 of Sarbanes-Oxley creates a federal civil right of action on behalf of any employee of a publicly traded company, or any employee of a contractor of a publicly traded company, who is subject to discrimination in retaliation for reporting corporate fraud or accounting abuses. Section 806 prohibits publicly traded companies ⁴ from discriminating ⁵ against an employee in retaliation for any lawful act done by the employee to:

- (1) provide information or otherwise assist in any investigation involving corporate fraud or accounting abuses, provided the investigation is conducted by a federal regulatory or law enforcement agency, any Member of Congress or Congressional Committee, or a publicly traded company or contractor with the authority within the
- (2) file, testify, participate in, or otherwise assist in any proceeding related to an alleged violation of corporate fraud laws or regulations.

Significantly, the passage underlined above protects “internal” whistleblowers who provide information during internal corporate investigations, as well as “external” whistleblowers who bring their concerns to the attention of law enforcement agencies.

An employee alleging discharge or other discrimination in retaliation for engaging in any of these protected activities may file a complaint with the U.S. Department of Labor (DOL) within

90 days of the violation. Within 60 days after receiving a complaint, and after giving the employer an opportunity to respond, the Secretary of Labor will conduct an investigation to determine whether the complaint has merit. When the investigation is completed, the Secretary will issue a preliminary order, which may require reinstatement of the complainant, payment of back pay with interest, and compensation for special damages.

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Within 30 days of notification of the Secretary’s findings, either party may file objections and request a hearing. If a hearing is not requested within 30 days, the preliminary order becomes a final order. Hearings are conducted before a DOL administrative law judge, who issues a recommended decision that the Secretary can adopt as a final decision.

If the Secretary has not issued a final decision within 180 days of the filing of the complaint, the complainant may bring an action in the appropriate federal district court, without regard to the amount in controversy. The employee may recover compensatory damages, including back pay with interest, and special damages sustained as a result of the discrimination, including litigation costs and attorney’s fees. In addition, a prevailing complainant would be entitled to reinstatement with the same seniority status the complainant would have had but for the discrimination. ⁶

Criminal penalties for retaliation

Section 1107, titled “Retaliation Against Informants,” imposes criminal penalties on any individual who “knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense.” This provision supplements the existing federal criminal

penalties for witness intimidation. The penalties include a fine and/or imprisonment up to ten years.

In contrast to the civil remedies created by Section 806, the criminal provisions of Section 1107 are not limited to the actions of publicly traded companies; nor are they restricted in scope to matters involving corporate fraud or accounting abuses. However, Section 1107 is limited to “external” whistleblowers and does not by its terms protect “internal” whistleblowers who only voice concerns within their employers’ organizations.

Congress wished to protect employees of accounting firms, law firms, or other contractors who report concerns about financial fraud, whether the contractors themselves were privately or publicly held.

The potential scope of this new criminal statute is very broad. Federal crimes have been created by many labor and employment statutes, including the Occupational Safety and Health Act (for making false statements, for giving advance notice of inspections),⁷ the National Labor Relations Act (for loans by management to unions, for willfully interfering with agents of the Board, for employing felons convicted of certain crimes as union employees),⁸ the Employee Retirement Income Security Act (for employing convicted felons as fiduciaries),⁹ the Railway Labor Act (for refusal to obey certain sections of the statute),¹⁰ and many more too numerous to list here. There are federal crimes in the environmental protection statutes, securities statutes, and the Food and Drug Act. In addition, corporations have been criminally prosecuted under the federal conspiracy statute, the Racketeer Influenced and Corrupt Organizations Act, the mail and wire fraud statutes, the Foreign Corrupt Practices Act, the tax laws, perjury statutes, and obstruction of justice statutes. In reviewing these partial lists, it is apparent that many employees who provide information to law enforcement officials could potentially fall within the protections of the criminal provisions of Sarbanes-Oxley, and that many companies and individual managers could face criminal prosecutions under Sarbanes-Oxley.¹¹

“Undersight” protection is not limited to publicly traded companies

There is a common misconception that Sarbanes-Oxley applies only to publicly traded companies. This is a dangerous error with regard to the statute’s whistleblower protection provisions.

The civil whistleblower protections apply on their face to contractors of publicly traded companies. This is easily remembered if one recalls the example discussed in the Congressional debates of employees of the Arthur Andersen accounting firm who could not effectively blow the whistle on the fraud at Enron. Clearly, Congress wished to protect employees of accounting firms, law firms, or other contractors who report concerns about financial fraud, whether the contractors themselves were privately or publicly held. Also, the early cases decided under Sarbanes-Oxley have protected employees of privately held subsidiaries of publicly traded companies on the theory that the finances of the private subsidiaries have an effect on the financial reports of the public parents.¹² Importantly, the criminal protections under Sarbanes-Oxley are not limited to publicly traded companies.

Applying these principles in practice, it is clear that many privately held enterprises on Wall Street and elsewhere, including investment banks, accounting firms, and law firms, may be subject to both the civil and criminal “undersight” provisions of Sarbanes-Oxley.

Why be Concerned About Whistleblower Claims?

Whistleblower litigation usually causes more reputational injury than other forms of employment litigation because whistleblower claims necessarily involve public accusations that a company has done something wrong and is trying to cover it up. Sarbanes-Oxley whistleblower litigation can be even more damaging to corporate reputation. Many employers have decided to minimize their financial exposure to employment litigation by insuring against it. However, no amount of insurance can undo the negative publicity that often flows from public accusations that a company has engaged

in fraud. Such accusations may trigger investigations by the SEC, even if they turn out to be unfounded.

In addition to the reputational risk inherent in Sarbanes-Oxley whistleblower litigation, employers can no longer rely on peer pressure to discourage whistleblowers as “snitches,” “tattle-tales,” or worse. Today, whistleblowers often are honored in public. For example, *TIME* magazine named three whistleblowers (Cynthia Cooper/WorldCom, Colleen Rowley/FBI, and Sherron Watkins/Enron) as Persons of the Year for 2002. Moreover, the workforce appears to be very aware of the Sarbanes-Oxley whistleblower protections because claims under those provisions are the fastest growing category of cases within the U.S. Department of Labor. Clearly, employers should not rely on ignorance of the law, or the deterrent effect of peer pressure, as their only defenses against whistleblower claims.

Steps Employers May Take to Avoid Whistleblower Litigation

A whistleblower claim can generate negative publicity, which may undermine investor confidence, draw the attention of regulators, and weaken employee morale and loyalty. Here are some steps companies can take to avoid such claims.

Establish an Employee Concerns Program. Establishing a forum in which employees can raise concerns and have some assurance that their concerns will be investigated is an effective means of resolving an employee’s grievance before a lawsuit is filed. In addition, an Employee Concerns Program can help alert management to wrongdoing early on, providing an opportunity to intervene and prevent further damage.

Train managers and supervisors to instill a transparent corporate culture. One of the lessons of the recent accounting scandals is the importance of maintaining a culture conducive to raising concerns. Indeed, Congress appears to have concluded that many of the companies whose conduct precipitated Sarbanes-Oxley had cultures in which employees were dissuaded from asking probing questions and dissent was discouraged. Managers and supervisors should

be trained to encourage employees to raise concerns and question activities without fear of reprisal.

Take disciplinary action against those who engage in retaliation. All employees should be put on notice (e.g. through training and the employee handbook) that if they harass or discriminate against another employee for raising a concern, they will be subject to disciplinary action.

Document performance issues, contemporaneously. In defending against a whistleblower claim, it is critical to have thorough, unambiguous evidence demonstrating that the same unfavorable personnel action would have been taken in the absence of the complainant’s protected conduct. Accordingly, managers should thoroughly document performance issues on a routine basis. If there is not a contemporaneous documentary record of performance issues, then it may appear that the employer is making up performance issues after the fact to justify the adverse personnel action.

Conclusion

What price is worth paying to avoid future repetitions of Enron, WorldCom, and the like? It is clear from reading Sarbanes-Oxley that Congress was determined to change corporate culture by encouraging whistleblowing about fraud on the financial markets. The U.S. capital markets have been the primary engine of the world’s economic growth in the last several centuries. If the Sarbanes-Oxley provisions that facilitate “undersight” actually deter fraud and restore trust in those markets, then vigorous compliance with those provisions may be a reasonable price indeed. ●

- 1 S. Rep. No. 107-146, 107th Congress, 2d Sess., at 5.
- 2 See 17 C.F.R. Part 205.
- 3 See New York Stock Exchange Listed Company Manual, Section 303A, and National Association of Securities Dealers, Inc. Rule 4350(m), and Interpretive Memorandum.
- 4 Under Sarbanes-Oxley, any company that must either register its securities or file reports under the Exchange Act is considered a publicly traded company.
- 5 Discriminatory conduct includes harassment, demotion, suspension, and termination.
- 6 Section 806 does not supplant or replace other remedies available to employees under federal or state law or under any collective bargaining agreement. For a complete explanation of the complaint procedure for whistleblowers, see David B.H. Martin,

Barbara Hoffman, and Erin F. Casey, "Whistleblower Protection Under the Sarbanes-Oxley Act," *WALL STREET LAWYER*, Oct. 2004, at 1.

7 *See* 29 U.S.C. § 666.

8 *See* 29 U.S.C. §§ 186, 504.

9 *See* 29 U.S.C. § 1111.

10 *See* 45 U.S.C. § 152.

11 The author is not aware of any criminal prosecutions that have been brought yet under the criminal whistleblower provisions of

Sarbanes-Oxley. However, it is not hard to imagine that a federal prosecutor might wish to list on his or her resume the prosecution of an executive who terminated a whistleblower.

12 *See* *Morefield v. Exelon Services, Inc.*, 2004-SOX-2 (ALJ Jan. 28, 2004), available at <www.oalj.dol.gov/public/wblower/decsn/04sox02a.htm>. A comprehensive library of Sarbanes-Oxley whistleblower decisions issued by administrative law judges within the U.S. Department of Labor can be found at <www.oalj.dol.gov/public/wblower/refrnc/sox1list.htm>.