SEC Examinations May Include Whistleblower Rule Compliance

By David S. McCarthy

The SEC's Office of Compliance Inspections and Examinations (OCIE) has issued a Risk Alert warning registered investment advisers and broker-dealers that examinations under the National Exam Program may include a review of compliance with key provisions of the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1] The staff of OCIE is reviewing, among other things, compliance manuals, codes of ethics, employment agreements and severance agreements to determine whether provisions in those documents pertaining to confidentiality and reporting of potential securities law violations may have a chilling effect on whistleblowing to the SEC. The Risk Alert follows a string of settled enforcement actions in which confidentiality provisions in various agreements were found to violate Rule 21F-17, the rule that prohibits impeding communications to the SEC.

Background

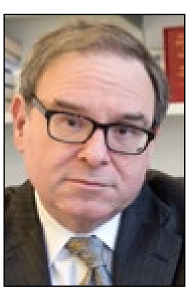
Section 21F of the Securities Exchange Act of 1934, enacted as part of the Dodd-Frank Act., created a system of incentives for corporate whistleblowers to report possible violations of the securities laws to the SEC by providing financial bounties, prohibiting employment-related retaliation, and providing various confidentiality guarantees. In order to support the purposes of Section 21F, the SEC adopted Rule 21F-17, which provides in part that:

> No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications.

The Enforcement Actions

The enforcement actions dealt with registrants using confidentiality provisions in a variety in contexts.

In *In the Matter of KBR, Inc.*,[2] the company, as part of its regular compliance program, from time to time received complaints from its employees about potential illegal or unethical conduct by the



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company and its employees, including allegations of potential violations of the federal securities laws. KBR's practice was to conduct internal investigations, which included interviews of employees, including employees originally lodging complaints. As part of the interviews, investigators had witnesses sign a confidentiality statement that prohibited discussing the interview or the subject matter of the interview without the prior authorization of the legal department. By signing these statements, the employees acknowledged that unauthorized disclosure could be grounds for disciplinary action, including termination.

In *In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated et al,*[3] certain severance agreements prohibited departing employees from disclosing confidential information or trade secrets of the company except pursuant to formal legal process or unless the former employee first obtained the written approval of an authorized company representative. While the agreements expressly permitted an individual to disclose confidential information pursuant to an order or other requirement of a court, administrative agency, or other authority, the agreements did not permit an individual to voluntarily disclose confidential information to such bodies. Later, the company added a provision to its severance agreements that did not prohibit initiating communications directly with the SEC or other authorities, but limited the types of information that could be conveyed to information relating to the severance agreement itself or "its underlying facts and circumstances."

Section 21F of the [Exchange Act] … created a system of incentives for corporate whistleblowers to report possible violations of the securities laws to the SEC by providing financial bounties, prohibiting employment-related retaliation, and providing various confidentiality guarantees.

In *In the Matter of BlueLinx Holdings Inc.,*[4] the company entered into various forms of severance agreements with departing employees as a condition to the employees receiving certain severance benefits. The agreements prohibited employees from sharing with anyone confidential information concerning BlueLinx that the employee had learned while employed by the company, unless compelled to do so by law or legal process. The confidentiality provisions contained in the agreements also required employees either to provide written notice to the company or to obtain written consent from the company's legal department prior to providing confidential information pursuant to such legal process. Certain of the agreements required that employees waive the right to receive whistleblower awards.

In *In the Matter of Health Net, Inc.,*[5] the company entered into severance agreements that contained a provision that prohibited filing an application for, or accepting, a whistleblower award as a condition to receiving monetary severance benefits. While subsequent iterations of the severance agreement dropped the prohibition on applying for whistleblower awards, the agreements still required employees to waive the right to receive an award.

In *In the Matter of Anheuser-Busch InBev SA/NV,*[6] the company entered into a separation agreement with an employee of a subsidiary who had been terminated after internally reporting potential misconduct. The separation agreement limited disclosures to the extent required for accounting or tax purposes or otherwise required by law. The agreement also contained a provision requiring payment by the employee of substantial liquidated damages for violations of the confidentiality provisions. The employee had been voluntarily communicating with the staff of the SEC prior to entering into the severance agreement, but stopped doing so because he believed he was prohibited from doing so by the agreement, and so risked triggering the liquidated damages provisions. The employee resumed communications with the staff only after receiving an administrative subpoena.

In each of these cases, the SEC made a finding that the relevant provisions of these agreements -- whether prohibiting voluntary disclosure to the SEC, waiving the right to apply for or receive a whistleblower bounty, or requiring written notice to or consent from the company before communicating with the SEC -- violated Rule 21F-17 by impeding communications. In a number of these cases, the SEC acknowledged that it was unaware of instances in which (i) communications with the SEC concerning potential securities laws violations had in fact been prevented or (ii) the registrant had taken action to enforce such provisions or otherwise prevent such communications. Nonetheless, the orders note that the potential loss of employment, a severance benefit, or a whistleblower bounty are effective methods of chilling communication and are inconsistent with the stated purpose of the Section 21F and Rule 21F-17, which is to "encourage[e] individuals to report to the [SEC]".[7]

Broker-dealers and investment advisers should review compliance manuals, codes of ethics, employment agreements and severance agreements for impermissible language.

The orders imposed the following types of remedial measures (in addition to monetary penalties):

- revising documents on a going-forward basis to make it clear that nothing contained in them prohibits employees or former employees from voluntarily communicating with the SEC or other authorities regarding possible violations of law, without notice to the employer, or from recovering a Commission whistleblower award;
- providing general notice to employees, or notice to employees who signed restrictive agreements, of their right to contact the SEC or other authorities; and
- contacting former employees who signed severance agreements to inform them that the company does not prohibit them from communicating with the SEC or seeking a whistleblower award.

The Risk Alert

The Risk Alert indicates that in connection with reviews of the registrants' compliance with Rule 21F-17, SEC staff will analyze a variety of documents, including:

- compliance manuals;
- codes of ethics;
- employment agreements; and
- severance agreements.

SEC staff will assess whether these documents contain provisions similar to those in agreements that SEC has found to violate Rule 21F-17, including provisions that: (a) purport to limit the types of information that an employee may convey to the SEC or other authorities; and (b) require departing employees to waive their rights to any individual monetary recovery in connection with reporting information to the government.

The Risk Alert also notes that staff will assess whether these documents contain other provisions that may contribute to violations of Rule 21F-17 in circumstances where their use impedes employees or former employees from communicating with the SEC, such as provisions that:

- prohibit any and all disclosures of confidential information, without any exception for voluntary communications with the SEC concerning possible securities laws violations;
- require an employee to notify and/or obtain consent from the registrant prior to disclosing confidential information, without any exception for voluntary communications with the Commission concerning possible securities laws violations; or
- purport to permit disclosures of confidential information only as required by law, without any exception for voluntary communications with the Commission concerning possible securities laws violations.

All of these suspect provisions parallel those at issue in the enforcement actions. In addition, the Alert notes that provisions requiring an employee to represent that he or she has not assisted in any investigation involving the registrant may also violate Rule 21F-17.

When examining registrants' compliance with Rule 21F-17, the SEC staff will cite deficiencies and make referrals to the Division of Enforcement where appropriate.

Recommended Steps

Broker-dealers and investment advisers should review compliance manuals, codes of ethics, employment agreements and severance agreements for impermissible language. Training materials and internal investigation protocols should be reviewed as well.

The following steps should be considered:

1. On a going-forward basis, registrants should make sure newly executed employment and severance agreements do not directly or indirectly impede communications with the SEC. Agreements should categorically avoid including waivers of whistleblower bounties or requiring an employee to represent that he or she has not assisted in any investigation. A prudent approach would be to continue to use broadly drafted confidentiality provisions, but then to add a clause tailored to permit voluntary communications to the SEC concerning possible violations of law without permission from or notice to the employer.

An example of such a clause could read as follows:

"*Protected Rights.* Employee understands that nothing contained in this Agreement limits Employee's ability to communicate voluntarily with the SEC regarding possible securities law violations, including providing documents or other information, without notice to, or authorization by, the Company. This Agreement does not limit Employee's right to apply for or receive an award for information provided to the SEC."

Similar clauses featured as remedies in the enforcement actions are more expansively drafted, referencing communications to other government entities and other whistleblowing programs.[8] Arguably, the scope of these remedies exceeds the four corners of Rule 21F-17; the expansive scope is almost certainly a result of settlement negotiations. Notwithstanding the limitation of the rule, registrants need to consider whether a more expansive clause is appropriate given passing references in the Risk Alert to limits on reporting to "other authorities", as well as recent initiatives at the Equal Employment Opportunity Commission.[9] In addition, the recently enacted Defend Trade Secrets Act, which created a new federal civil cause of action for trade secret misappropriation, limits certain remedies against an employee if the employee has not received notice that confidential reporting is permitted to a federal, state or local government official, or to an attorney, for the purpose of reporting or investigating a suspected violation of law.[10]

2. Registrants should develop a strategy for dealing with existing restrictive agreements with current employees that contain provisions identified as problematic by the Risk Alert. The Risk Alert suggests that delivering a notice of the right to contact the SEC regarding possible violations of securities laws and the right to seek a whistleblowing award should be sufficient.
3. Registrants should consider whether to notify former employees who are parties to severance agreements that contain provisions identified as problematic by the Risk Alert. Registrants may wish to consider a risk based approach, in which notices are sent only to more recently terminated employees. Based on the enforcement actions, in no event should it be necessary to notify parties to severance agreements entered into before August 12, 2011 (the date of publication of the adopting release for the SEC whistleblowing rules.)
4. Training materials, compliance manuals and codes of ethics, particularly concerning internal or external reporting of possible violations of law, should be updated to comply with the guidance in the Risk Alert. For example, in *Merrill Lynch,* the registrant provided all employees in mandatory yearly training a document entitled "Notice Concerning Your Rights to Report Possible Violations of Law" The notice, among other things, sets forth an employee's rights to report to, and cooperate with, the SEC, as well as employee rights under the SEC's whistleblower program.
5. Internal investigation scripts and protocols should be reviewed to make sure that any request to retain confidentiality clearly excludes the right to voluntarily report possible illegal activity to the SEC without authorization from or notification to the company. Under no circumstances should an employee be asked to represent that he or she will not report or has not reported to the SEC, or to waive the right to apply for, or receive, an SEC whistleblower bounty.

ENDNOTES

1 *Examining Whistleblower Rule Compliance,* SEC OCIE National Exam Program Risk Alert, Volume VI, Issue 1 (October 24, 2016), https://www.sec.gov/files/ocie-2016-risk-alert-examining-whistleblower-rule-compliance.pdf

2 *In the Matter of KBR, Inc.*, Release No. 34-74619 (April 1, 2015), https://www.sec.gov/litigation/admin/2015/34-74619.pdf

3 *In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated et al*, Release No 34-78141 (June 23, 2016), https://www.sec.gov/litigation/admin/2016/34-78141.pdf

4 *In the Matter of BlueLinx Holdings Inc.*, Release No. 34-78528 (Aug. 10, 2016), https://www.sec.gov/litigation/admin/2016/34-78528.pdf

5 *In the Matter of Health Net, Inc.,* Release No 34-78590 (Aug. 16, 2016), https://www.sec.gov/litigation/admin/2016/34-78590.pdf

6 *In the Matter of Anheuser-Busch InBev SA/NV*, Release No. 34-78957 (Sept. 28, 2016), https://www.sec.gov/litigation/admin/2016/34-78957.pdf

7 *Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934*, Release No. 34-64545 (Aug. 12, 2011), http://www.sec.gov/rules/final/2011/34-64545.pdf at p. 201

8 For example, the following is the clause provided for as a remedy in *BlueLinx*:

> "*Protected Rights*. Employee understands that nothing contained in this Agreement limits Employee's ability to file a charge or complaint with the Equal Employment Opportunity Commission, the National Labor Relations Board, the Occupational Safety and Health Administration, the Securities and Exchange Commission or any other federal, state or local governmental agency or commission ("Government Agencies"). Employee further understands that this Agreement does not limit Employee's ability to communicate with any Government Agencies or otherwise participate in any investigation or proceeding that may be conducted by any Government Agency, including providing documents or other information, without notice to the Company. This Agreement does not limit Employee's right to receive an award for information provided to any Government Agencies.

The following is the clause agreed to in the revised *KBR* confidentiality statement:

> Nothing in this Confidentiality Statement prohibits me from reporting possible violations of federal law or regulation to any governmental agency or entity, including but not limited to the Department of Justice, the Securities and Exchange Commission, the Congress, and any agency Inspector General, or making other disclosures that are protected under the whistleblower provisions of federal law or regulation. I do not need the prior authorization of the Law Department to make any such reports or disclosures and I am not required to notify the company that I have made such reports or disclosures.

9 E.g., *Equal Employment Opportunity Commission v. CVS Pharmacy, Inc.*, civil action no. 14-cv-863 (N.D. Ill. 2014) (EEOC challenge of confidentiality provisions in separation agreement as unlawfully limiting communications with the EEOC in violation of Title VII; dismissed for failure to conciliate and to failure to allege discrimination or retaliation. See *EEOC v. CVS Pharmacy, Inc.,* 809 F.3d 335 (7th Cir. 2015))

10 See *Schiff Hardin LLP Trending Legal Issues: NDA Alert: Modify Your Non-Disclosure Agreements to Preserve All Remedies Under the New Federal Trade Secrets Statute*, (September 36, 2016), http://www.schiffhardin.com/insights/publications/2016/the-first-federal-civil-trade-secrets-law-is-now-effective