PUBLICATION

SEC, FINRA and the DOL Take Aim at Confidentiality Provisions in Firm Agreements

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November 18, 2016

On October 24, 2016, the United States Securities and Exchange Commission (SEC)'s Office of Compliance Inspections and Examinations (OCIE) released an alert examining whistleblower rule compliance and the use of confidentiality provisions. The alert continues the trend of increased scrutiny by regulators in this area. Accordingly, firms need to reexamine their provisions to ensure they do not run afoul of the regulators' concerns.

I. The OCIE's Alert

The alert informs firms that the OCIE will examine both investment advisers' and broker-dealers' compliance with SEC Rule 21F-17, which prohibits "any action to impede an individual firm communicating directly with the [SEC] staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement." These exams will focus on the review of compliance manuals, codes of ethics, employment agreements and severance agreements to determine whether provisions in those documents pertaining to confidentiality of information and reporting of possible securities law violations raise concerns under Rule 21F-17.

Specifically, the OCIE will assess whether these documents contain provisions that have been found to violate Rule 21F-17, including provisions that: "(a) purport to limit the types of information that an employee may convey to the Commission 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 OCIE will also assess whether these documents contain any other provisions that may impede employees or former employees from communicating with the SEC. According to the OCIE, such provisions include those that require employees to represent that they have not assisted in any investigation, prohibit any and all disclosures of confidential information, require employees to notify/obtain consent from the firm before disclosing confidential information and purport to permit disclosures of confidential information only as required by law, without any exception for voluntary communications with the SEC. These reviews will be included in examinations as the OCIE deems appropriate.

II. Background

The SEC's continued focus in this area is not surprising. As we wrote a year ago, confidentiality provisions included in settlement agreements, employment or independent contractor contracts and in other documents have already come under increased scrutiny in the financial industry. The SEC, the Financial Industry Regulatory Authority (FINRA) and the United States Department of Labor (DOL) have each introduced guidance prohibiting confidentiality provisions that impede the whistleblowing process or obstruct investigations and prosecutions by regulators. In October 2014, FINRA issued Regulatory Notice 14-40, reminding firms that it is a violation of FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) to include confidentiality provisions in settlement agreements or any other documents, including confidentiality stipulations made during FINRA arbitration proceedings, that prohibit or restrict a customer or any other person from communicating with the SEC, FINRA, or any federal or state regulatory authority regarding a possible

securities law violation. In light of the regulators' scrutiny in this area, firms began to carefully craft confidentiality provisions in their agreements to avoid running afoul of the regulators' concerns.

III. Recent Developments

The SEC

In August of 2016, the SEC brought an enforcement action against the Atlanta-based construction product distributor, BlueLinx Holdings Inc., for including a provision in its severance agreements that required outgoing employees to waive their rights to monetary recover if they filed a charge or complaint with the SEC or other federal agencies. Specifically, the SEC found that, because the severance agreement required employees leaving BlueLinx to waive potential whistleblower awards or risk losing payments and other benefits under the agreement, the agreement violated Rule 21F-17. BlueLinx ultimately agreed to pay a $265,000 penalty for this violation.

Notably, the SEC's order suggested this clause for use in severance agreements:

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 key addition is the last sentence, which explicitly provides that employees have the right to collect a reward for their "tips." The SEC also filed an enforcement action against Health Net, Inc., raising similar concerns. Health Net agreed to pay a penalty of $340,000. In announcing these settlements, Jane Norberg, acting chief of the SEC's Office of the Whistleblower, summarized the SEC's concerns stating: "[c]ompanies simply cannot undercut a key tenet of our whistleblower program by requiring employees to forego potential whistleblower awards in order to receive their severance payments[.]"

These are not the first cases in which the SEC charged violations of Rule 21F-17. As discussed in our previous article in April 2015, KBR settled charges last year in connection with its use of certain restrictive language in confidentiality agreements used in the course of an internal investigation that warned employees could face discipline and even be fired if they discussed the matters with outside parties without the prior approval of KBR's legal department (without an SEC whistleblower carve-out). Similarly, in June this year, the SEC charged that, among other violations, Merrill Lynch prohibited former employees from disclosing confidential information in violation of Rule 21F-17 by including similar provisions in its severance agreements.

Accordingly, these actions make it clear that the SEC views its whistleblower program as critical to its enforcement program, and will aggressively punish firms that, in the SEC's view, attempt to hamper individuals' ability or incentives to become SEC whistleblowers.

The DOL

The DOL issued a memorandum in August of 2016, which provided that companies cannot prohibit their former employees from collecting whistleblower awards. Because the DOL's memo relates to the review of agreements settling complaints filed with OSHA, it necessarily extends the SEC's position to whistleblowing programs that apply to nonpublic companies.

As previously discussed, regulators have repeatedly taken the position that confidentiality agreements cannot deter an employee from communicating with the government, with or without notice to the employer. The DOL's memo also calls foul on provisions that require employees to affirm that they have not previously provided information to the government, or to disclaim any knowledge that the employer has violated the law. Both of these affirmations are described as potentially "compromis[ing]" statutory and regulatory mechanisms for employees to provide information confidentially to the government. In fact, the DOL's memo provides that it may require companies to take affirmative action to remedy these issues by amending such offending provisions to include language acknowledging employees' rights and responsibilities under federally-administered whistleblower award programs.

IV. Takeaways

Like the orders against Merrill Lynch and KBR, the SEC's latest orders demonstrate its propensity to hold companies liable for Rule 21F-17 violations without any evidence that employees actually had been prevented from disclosing confidential information to the government. The DOL's memo reaffirms these principles in the employment severance agreement context. In other words, the SEC and DOL appear to be taking a proactive rather than reactive approach and have made it clear that they have no patience for impeding whistleblowing in any form. Their scrutiny would likely extend to confidentiality provisions in any agreement, including settlement agreements, if the language can be construed as prohibiting whistleblowing. Therefore, companies should expect a high level of scrutiny of confidentiality provisions, particularly in employment agreements.

To ensure compliance with the concerns of the SEC, FINRA and the DOL, firms should consider incorporating language substantially similar to the following in all confidentiality provisions, whether they be in employment agreements, settlement agreements or otherwise:

Nothing in this confidentiality provision prohibits me from initiating communications directly with, or responding to any inquiry from, or providing testimony before, the United States Securities and Exchange Commission, the Financial Industry Regulatory Authority, any other self-regulatory organization or any other state or federal regulatory authority, including, but not limited to, the Department of Justice, Congress, and any Inspector General, or from otherwise reporting possible violations of federal law or regulation to any governmental agency, governmental entity, or self-regulatory organization, or making other disclosures that are protected under the whistleblower provisions of federal law or regulation. I do not need prior authorization from my firm to make any such reports or disclosures and I am not required to notify my firm that I have made such reports or disclosures. Further, this provision does not limit me from receiving an award for information provided under a whistleblower statute to any governmental agency.

V. Conclusion

The foregoing guidance underlines the importance of carefully crafting confidentiality provisions in both settlement agreements and employment or independent contractor agreements. In light of the regulators' scrutiny, firms should routinely assess their confidentiality provisions to ensure compliance with ever-changing laws and regulations governing the financial and employment industries.

If you have any questions regarding these issues or any other securities related matters, please contact one of the attorneys in Baker Donelson's Broker-Dealer/Registered Investment Adviser Group.