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SEC Cracks Down On Confidentiality Agreements As Violating Whistleblower Rights And Protections

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

On April 1, 2015, the SEC announced its first filed, and settled, enforcement action against a company for using improperly restrictive language in confidentiality agreements as a method to stifle or retaliate against whistleblowers.

In recent months, the SEC has been issuing requests to companies for copies of confidentiality agreements, non-disclosure agreements, employment agreements, severance agreements and settlement agreements entered into with employees and former employees of the companies. The initiative specifically requests copies of documents since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) and, in particular, the provisions of the Dodd Frank-Act which grant awards and protections for whistleblowers.

In addition, the SEC has been asking for copies of company human resource policies, employee memos, training guides and any and all documents that discuss “whistleblowers” either directly or indirectly. According to a Wall Street Journal article on the subject, the SEC believes that corporations are retaliating against potential whistleblowers and attempting to curb against the whistleblowing incentives in the Dodd-Frank Act by providing detriments to employment in contracts and policies veiled as confidentiality protections.

The Dodd-Frank Act directly prohibits retaliatory conduct by companies. The SEC has found the whistleblower statute to be extremely beneficial in uncovering and prosecuting large-scale securities fraud. In essence the whistleblower statute, and potential monetary awards for successful prosecutions, provides the SEC with an army of investigators well beyond what the agency could afford using its own resources.

The KBR Case

In the action filed on April 1st, the SEC charged KBR, Inc. with violating Rule 21F-17 under the Dodd-Frank Act. In this case, KBR required employees participating in internal investigations related to potential securities law violations, to sign confidentiality agreements that prohibited the employee from discussing the matter with outside parties without KBR approval with a consequence of discipline or termination in the event of a violation of such confidentiality agreement. As the investigations included allegations of securities law violations, the terms in the agreement were found to violate Rule 21F-17 of the Dodd-Frank Act, which specifically prohibits companies from taking any action to impede whistleblowers from reporting possible securities law violations to the SEC. Rule 21F-17 is discussed in more detail below.

KBR agreed to pay a penalty of \$130,000 and to amend its confidentiality statement to make it clear that employees are free to report possible violations to the SEC and other federal agencies without KBR approval or fear of retaliation. This specific language inviting employees to report would likely have not been required if KBR had not had prohibitive language in the first place.

In its press release on the matter, Andrew J. Ceresney, SEC Director of the Division of Enforcement, was quoted as saying, “By requiring its employees and former employees to sign confidentiality agreements imposing pre-notification requirements before contacting the SEC, KBR potentially discouraged employees from reporting securities violations to us, SEC rules prohibit employers from taking measures through confidentiality, employment, severance, or other type of agreements that may silence potential whistleblowers before they can reach out to the SEC. We will vigorously enforce this provision.”

The SEC enforcement action came despite the factual conclusion that no employee had actually been prevented from reporting a violation to the SEC or had sought to do so. The SEC is sending a clear message that any efforts to chill whistleblowers will be considered a violation of the rules.

The Dodd-Frank Act Whistleblower Statute

The Dodd-Frank Act, enacted in July, 2010, added Section 21F, “Whistleblower Incentives and Protection” to the Securities Exchange Act of 1934 (“Exchange Act”). As stated in the original rule release and the SEC order against KBR, the purpose of the

rule was “to encourage whistleblowers to report possible violations of the securities laws by providing financial incentives, prohibiting employment related retaliation, and providing various confidentiality guarantees.”

The bulk of the whistleblower statutes relate to the submission of original information leading to successful enforcement actions, and the calculation and payment of awards to the whistleblower. The statute implements measures to protect the whistleblower from retaliatory actions.

Rule 21F-2, “Whistleblower status and retaliation protection,” defines a whistleblower as follows:

(a)(1) You are a whistleblower if, alone or jointly with others, you provide the Commission with information pursuant to the procedures set forth in § 240.21F-9(a) of this chapter, and the information relates to a possible violation of the Federal securities laws (including any rules or regulations thereunder) that has occurred, is ongoing, or is about to occur. A whistleblower must be an individual. A company or another entity is not eligible to be a whistleblower.”

(b) Prohibition against retaliation. (1) “[F]or purposes of the anti-retaliation protections..., you are a whistleblower if: (i) you possess a reasonable belief that the information you are providing relates to a possible securities law violation... that has occurred, is ongoing, or is about to occur, and; (ii) you provide that information in a manner described in Section 21F(h)(1)(A); (iii) The anti-retaliation protections apply whether or not you satisfy the requirements, procedures and conditions to qualify for an award.”

Rule 21F-17, “Staff communications with individuals reporting possible securities law violations,” which is the subject of the KBR enforcement action, provides:

(a) “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.”

Conclusion

In light of the recent SEC action and recent documentation requests, this firm has made particular modifications to its form of confidentiality agreements, non-disclosure

agreements, employment agreements, severance agreements and employee settlement agreements. In addition, we are reviewing existing forms used by our client companies to make the necessary modifications to avoid inadvertent violations that could result in an SEC enforcement action. We urge all companies to seek the advice of competent counsel prior to entering into any such contracts, and of course, when conducting internal investigations which include allegations of potential securities law violations. Additional enforcement actions are expected as the SEC continues to review documents requested and provided by various employer companies.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, TheSecurities Law Network.

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