The HEDGE FUND LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com | Volume 9, Number 33 | August 25, 2016

WHISTLEBLOWERS

How Hedge Fund Managers Can Balance Protecting Confidential Information Against Complying With Whistleblower Laws

By Anne E. Beaumont and Lance J. Gotko

Friedman Kaplan Seiler & Adelman LLP

Building upon the principles articulated in its April 2015 settlement with KBR, Inc., the SEC recently announced a settlement with BlueLinx Holdings Inc. relating to provisions the company had included in severance agreements. Those provisions restricted former employees' abilities to disclose the company's confidential information and to receive rewards as SEC whistleblowers. The BlueLinx and KBR consent orders together underscore the SEC's view that any provisions that might stifle an employee's communications with the SEC – either explicitly (as in KBR) or implicitly (as in BlueLinx) – are prohibited, regardless of the employer's intent, its efforts (or lack thereof) to enforce them or their actual chilling effect.

For more on whistleblowers, see "*Current and Former SEC, DOJ and NY State Attorney General Practitioners Discuss Regulatory and Enforcement Priorities*" (Jan. 14, 2016); and "*RCA Session Offers Insights on Dodd-Frank Whistleblower Regime, Incentives, Anti-Retaliation Protections and Risks*" (Apr. 9, 2015).

Overview of the Whistleblower Rules

In 2011, the Dodd-Frank Wall Street Reform and Consumer Protection Act amended the Securities Exchange Act of 1934 to add Section 21F, entitled "*Securities Whistleblower Incentives and Protection*." Section 21F has three mechanisms designed to encourage whistleblowers to report possible securities law violations – financial incentives (i.e., whistleblower awards), a prohibition on employment-related retaliation for whistleblowing and various confidentiality guarantees.

The SEC adopted Rule 21F-17 in August 2011, which provides, among other things, "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 KBR Settlement

On April 1, 2015, the SEC announced the settlement of what it billed as "its first enforcement action against a company for using improperly restrictive language in confidentiality agreements with the potential to stifle the whistleblowing process."

According to the SEC consent order, KBR – a Texas engineering firm – had required witnesses interviewed in internal investigations to sign a confidentiality statement that included language warning them that they could face discipline "up to and including termination of employment" for "discussing any particulars regarding this interview and the subject matter discussed during the interview" without prior authorization from KBR's law department.

In its consent order, the SEC found that this language impeded communications with SEC staff about potential securities law violations and undermined the purposes of Section 21F and Rule 21F-17(a), namely to encourage reporting to the SEC. Interestingly, the SEC acknowledged that there was no sign that any KBR employee had in fact been prevented from communicating directly with the SEC or that KBR had taken any action to enforce the agreements or otherwise actively prevent such communications.

As part of the settlement with the SEC, KBR paid a $130,000 civil money penalty and amended its confidentiality statement to include the following language:

> 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.

In addition, KBR agreed to make reasonable efforts to contact KBR employees who had signed the confidentiality agreement previously, and to clarify their rights and obligations in light of the settlement and the SEC's findings.

For further color on conducting internal investigations without violating SEC whistleblower rules, see "*How Hedge Fund Managers Can Protect Privileged Internal Investigations Without Violating SEC Whistleblower Rule 21F-17*" (May 21, 2015).

Hedge Fund Industry Reaction to KBR

Although the KBR matter focused on a single type of agreement – a confidentiality agreement – its impact has been wide-ranging, particularly in the hedge fund industry where confidentiality provisions may be found in a variety of documents, from non-disclosure agreements, employment agreements and severance agreements, to compliance manuals, codes of conduct and agreements with business and trading counterparties. Among other things, the effect of the KBR order on the attorney-client privilege in internal investigations has been closely watched. See also "*D.C. Circuit Confirms Applicability of Attorney-Client Privilege to Internal Investigations*" (Aug. 7, 2014).

The SEC also made clear immediately after announcing the KBR settlement that it is not just confidentiality agreements that are in the SEC's crosshairs. At the end of April 2015, SEC Chair Mary Jo White stated that "a number of other concerns have come to our attention, including that some companies may be trying to require their employees to sign agreements mandating that they forego any whistleblower award or represent, as a precondition to obtaining a severance payment, that they have not made a prior report of misconduct to the SEC," warning that such provisions would face scrutiny by the Enforcement Division. The SEC also has indicated publicly that it is targeting not only the firms that use offending provisions, but the personnel at those firms who are involved in crafting them – potentially including in-house legal and compliance personnel.

For coverage of additional commentary by regulators on the SEC's whistleblower program, see "*SEC Chair's Testimony Highlights SEC's Bolstered Presence in Asset Management Space*" (Jun. 16, 2016); and "*SEC Chair Emphasizes Enforcement Focus on Strong Remedies and Individual Liability*" (Nov. 12, 2015).

The BlueLinx Settlement

Chair White's April 2015 comments seem to directly foreshadow the recently announced BlueLinx settlement.

Beginning prior to the enactment of Section 21F, BlueLinx had required departing employees who were receiving severance payments to sign agreements that prohibited them from disclosing confidential information about BlueLinx learned in the course of their employment unless compelled to do so by law or legal process. The agreements also required them to provide written notice

The HEDGE FUND LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation
www.hflawreport.com Volume 9, Number 33 August 25, 2016

to the company or obtain prior written consent from BlueLinx's legal department before providing confidential information pursuant to such legal process.

None of the agreements at issue contained an express exemption permitting voluntary disclosure to the SEC or other regulatory or law enforcement agencies. The agreements defined "confidential information" broadly and also contained a provision requiring the employee to contact BlueLinx's legal department "[i]f the Employee has any question regarding what data or information would be considered by BlueLinx to be information subject to this provision."

In 2013, BlueLinx overhauled the documentation it used for departing employees and added or amended some of the provisions that an employee was required to accept as a condition of receiving severance payments and other consideration from the company. For example, while the type of confidentiality provisions noted above had been included in several of the forms of agreement that BlueLinx used, in 2013 they were added to BlueLinx's most frequently used form (known as a "Letter Agreement"), which most non-management departing employees were required to sign as a condition of receiving severance payments.

In addition, BlueLinx amended all of its severance documentation, including the Letter Agreement, by adding the following provision:

> Employee further acknowledges and agrees that nothing in this Agreement prevents Employee from filing a charge 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 administrative agency if applicable law requires that Employee be permitted to do so; however, Employee understands and agrees that Employee is waiving the right to any monetary recovery in connection with any such complaint or charge that Employee may file with an administrative agency.

According to the SEC, approximately 160 BlueLinx employees signed severance agreements that contained both the confidentiality provisions and the waiver of any whistleblower recovery.

In its consent order, the SEC found that these provisions both impeded departing employees' communications with the SEC – in violation of Rule 21F-17 – and improperly removed Section 21F's "critically important financial incentives" for employees to engage in such communications.

In settlement of the SEC's administrative action, BlueLinx agreed to pay a $265,000 civil money penalty and to include in its severance documentation "and/or any other agreements with its employees that include prohibitions on the use or disclosure of confidential information relating to the company" the following provision:

> 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.

Lessons for Hedge Funds

The SEC's consent order entered in connection with the BlueLinx settlement elaborates on what the SEC views as "impeding" employees' communications with the SEC. It makes clear that the lessons of KBR are not limited to confidentiality agreements and expressly are made applicable to severance agreements – as well as other types of employment and other business agreements.[1] For example, provisions that limit employee disclosures may be found in employment manuals, compliance manuals, offer letters and a variety of other documents.

Firms should pay special attention to any provision that limits employees' disclosures, and consider whether it could be read as "impeding" disclosures to the SEC. While the word "impede" – which the SEC itself chose to use in Rule 21F-17 – is an active word that suggests some level of intention or action, it has since been construed by the SEC much more broadly to mean anything that "chills" or "could be viewed as discouraging." In short, in drafting language that is intended to shield a firm's information from disclosure, it is critical to avoid even inadvertently inhibiting employees' whistleblowing communications.

While it is worthwhile for firms to take stock of and update any potentially problematic documentation they have been using, newly added language must be scrutinized carefully. For example, in the BlueLinx matter, the SEC noted that the company had added or supplemented much of the offending language after the enactment of Section 21F and the promulgation of Rule 21F-17 – albeit well before the announcement of the KBR settlement. Moreover, the stakes are particularly high for the drafters themselves in light of the SEC's expressed view that individuals as well as firms may be charged for violations of Rule 21F-17.[2]

Another important point is that the specific disclosure to which BlueLinx agreed, if mandated as a general matter, could be read as expanding employees' right to engage in communications with regulators well beyond the concerns of the federal securities laws. Specifically, the language that BlueLinx agreed to include in its agreements going forward is not limited to facilitating communications with and potentially receiving monetary awards from the SEC. Rather, it expressly permits disclosures to the Equal Employment Opportunity Commission (EEOC), the National Labor Relations Board and Occupational Safety and Health Administration as well as to "any other federal, state or local governmental agency or commission" – collectively defined as "Government Agencies" – and states that it "does not limit Employee's right to receive an award for information provided to any Government Agencies."

This sweeping language is problematic. As a threshold matter, it is highly questionable that a Dodd-Frank implementing regulation could extend the SEC's power to communications with and awards from state and local agencies and commissions.

In addition, even on a federal level, the inclusion of the EEOC in the definition of "Government Agencies" flies in the face of established employment practice. It is common for severance agreements to contain provisions that condition an employee's receipt of separation benefits on a waiver of the right to receive an award recovered in an action by the EEOC for discrimination. To the extent such an award is based on "information" provided to the EEOC by the employee, BlueLinx may call into question the continuing viability of such provisions. Although it is difficult to see how the whistleblower protection guaranteed by Section 21F and Rule 21F-17 could extend the SEC's authority to cover communications with and awards from the EEOC, the BlueLinx settlement creates some uncertainty on this point for now.

Nevertheless, the clear takeaway from KBR and BlueLinx is that firms should examine their documents – employment agreements, offer letters, severance agreements, confidentiality agreements, employee handbooks, compliance manuals and so on – for provisions that could be construed as "impeding" communications with the SEC or causing "impediments" to the SEC's whistleblower program. Confidentiality obligations should be tempered with language such as that agreed to by KBR, and no provision should erect any barriers to an employee's participation as an SEC whistleblower.

[1] Less than a week after the BlueLinx consent order, the SEC settled another administrative action – In the Matter of Health Net, Inc. – pursuant to which a California-based health insurance provider (Health Net) agreed to pay a $340,000 penalty for illegally using severance agreements that required employees to waive their abilities to obtain monetary awards from the SEC's whistleblower program. Specifically, the SEC found that in August 2011, after the SEC adopted Rule 21F-17, Health Net amended its form of severance agreement to state that while employees were not prohibited from participating in a government investigation, employees were expressly required to waive the right to file an application for award under Section 21F. In June 2013, Health Net amended its documentation to remove the explicit language prohibiting employees for applying for awards under Section 21F but continued to require employees to waive any rights to any individual monetary recovery associated with a government investigation or proceeding. It should be noted that, like the BlueLinx settlement, the SEC did not find any evidence that Health Net took action to enforce these provisions or that these provisions actually had a chilling effect on employee communications with the SEC. Nevertheless, the SEC concluded that the inclusion of these provisions in severance agreements was sufficient to violate Section 21F and Rule 21F-17(a).

[2] During any review of documents that impose confidentiality obligations, firms should note another trap for the unwary: the federal Defend Trade Secrets Act of 2016 requires employers to notify employees of the immunity from liability granted them by the Act under certain circumstances. Firms may want to consider adding language like the following to such documents: "Notwithstanding any provision herein to the contrary, and in accordance with the Defend Trade Secrets Act of 2016, the Company notifies the Employee that an individual cannot be held criminally or civilly liable under any federal or state trade secret law for the disclosure of a trade secret that: (A) is made in confidence to a federal, state, or local government official (either directly or indirectly), or to an attorney, solely for the purpose of reporting or investigating a suspected violation of law, or (B) is made in a complaint or other document filed in a lawsuit or other proceeding, if such filing is made under seal. The Company also notifies the Employee that an individual who files a lawsuit for retaliation by an employer for reporting a suspected violation of law may disclose the trade secret to the attorney of the individual and use the trade secret information in the court proceeding, if the individual files any document containing the trade secret under seal, and does not disclose the trade secret, except pursuant to a court order."

Anne E. Beaumont and Lance J. Gotko are litigation partners in the New York office of Friedman Kaplan Seiler & Adelman LLP. Ms. Beaumont's practice focuses on representation of hedge funds and their managers and investors as well as financial services litigation matters involving complex financial products. She also counsels a variety of counterparties in connection with margin calls, termination and close-out of derivatives transactions, and other issues relating to complex financial products, as well as counseling and training clients on legal compliance, due diligence and other issues.

Mr. Gotko heads Friedman Kaplan's employment practice group and represents companies and individuals in the financial services and other industries in connection with a wide variety of employment and complex commercial litigation matters, including in jury and non-jury trials and arbitrations. He provides advice and representation in disputes related to employment-related issues, separation agreements, group moves, compensation, misappropriation of trade secrets, breaches of non-compete agreements and fiduciary duty and discrimination.

