CLIENT UPDATE

SEC WARNS AGAINST INTERFERENCE WITH POTENTIAL WHISTLEBLOWERS

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Sean McKessy, Chief of the Office of the Whistleblower of the U.S. Securities and Exchange Commission ("SEC"), recently warned corporate counsels against drafting contracts that attempt to dissuade would-be whistleblowers from reporting company wrongdoing to the SEC. According to McKessy, his office is "actively looking for examples of confidentiality agreements, separation agreements, [and] employee agreements" that condition certain benefits on not reporting activities to regulators, including the SEC. In addition to warning of potential liability for the companies, McKessy specifically warned corporate counsel about drafting such provisions – reminding them of the SEC's power to bar lawyers from practicing before the SEC.[1]

Given the broad scope of the whistleblower rules promulgated under the U.S. Dodd-Frank Wall Street Financial Reform and Consumer Protection Act ("Dodd-Frank") and their application to public and private companies alike, U.S. private equity firms, and portfolio companies with operations in the United States, should take note of McKessy's warning. We recommend that such private equity firms and portfolio companies (1) review codes of conduct and existing and proposed new agreements with current and former employees (including employment agreements, carried interest arrangements containing confidentiality and non-disparagement covenants, other confidentiality and non-disparagement agreements, and severance

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1 *See* Commission's Rules of Practice, Rule 102(e), 17 C.F.R. § 201.102 (2011).

agreements) to ensure that those documents do not contain provisions that could run afoul of Dodd-Frank's whistleblower rules, particularly the anti-retaliation prohibitions of Rule 21F-17, and (2) consider the interplay of such provisions with the whistleblower rules before taking steps to enforce such provisions.

EMPLOYERS MAY NOT IMPEDE OR RETALIATE AGAINST WHISTLEBLOWERS

McKessy's statements are a useful reminder to private equity firms and portfolio companies that Dodd-Frank, which became law in 2010, imposed important changes in relation to whistleblower protection. In addition to creating financial incentives for whistleblowers who report securities law violations to the SEC (payments of up to 30 percent of monetary sanctions obtained by the government), Dodd-Frank also enhanced anti-retaliation protections for whistleblowers. The SEC created the Office of the Whistleblower and adopted Rules 21F-1 through 21F-17 to implement the whistleblower regime. Rule 21F-17 prohibits "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." McKessy's recent comments make clear that the SEC is interpreting this provision broadly and taking enforcement of the whistleblower rules seriously.[2]

Indeed, even before McKessy's public statement, the SEC was reported to have launched an investigation of an employer related to its confidentiality agreement that barred employees from disclosing fraud allegations to anyone, including federal investigators.[3] We expect that the SEC will keep a watchful eye on how private equity firms and portfolio companies address confidentiality agreements and other restrictive covenants in their agreements with employees to ensure that those provisions do not run afoul of the broad protections afforded whistleblowers by Dodd-Frank or water down the incentive structure for reporting violations created by the statute.

The SEC's broad reading of Rule 21F-17 is consistent with the SEC's expansive view of who is a whistleblower and Dodd-Frank's anti-retaliation provisions generally. As illustrated by the SEC's *amicus* filing in *Liu v. Siemens AG*—a case before the U.S. Second Circuit Court

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2 The U.S. Supreme Court also recently expanded whistleblower protections under the U.S. Sarbanes-Oxley Act of 2002 ("SOX"). Specifically, the Supreme Court found that SOX whistleblower protections extend to employees of private companies that perform services for public companies. For a more thorough discussion, see Debevoise & Plimpton, Client Update: Supreme Court Gives SOX Whistleblower Provision Expansive Reading (Mar. 7, 2014), *available at* http://www.debevoise.com//clientupdate20140307a.

3 Scott Higham, *SEC Has Opened Investigation into KBR, Whistleblower's Lawyer Says*, WASH. POST, Mar. 10, 2014, *available at* http://www.washingtonpost.com/world/national-security/sec-has-opened-investigation-into-kbr-whistleblowers-lawyer-says/2014/03/10/d09ed14e-a883-11e3-8d62-419db477a0e6_story.html.

of Appeals addressing the issue of whether an internal whistleblower must report wrongdoing to the SEC to qualify for the anti-retaliation protections of Dodd-Frank—the SEC believes its Rule 21F-2 "protects any employee who engages in any of the [specified] whistleblowing activities . . . irrespective of whether the employee separately reports the information to the [SEC]."[4] Notably, the Fifth Circuit has taken the contrary position: whistleblowers may only avail themselves of the anti-retaliation protections of Dodd-Frank if they report wrongdoing to the SEC.[5] These differing interpretations will likely ultimately be settled by the Supreme Court.

RECOMMENDATIONS

In light of the recent publicity around whistleblower rewards[6] as well as McKessy's comments on vigilance around confidentiality agreements, U.S. private equity firms and portfolio companies with operations in the United States should review their codes of conduct and existing agreements with current and former employees (including employment agreements, carried interest arrangements containing confidentiality and non-disparagement covenants, other confidentiality and non-disparagement agreements, and severance agreements) to ensure that those documents are not so broadly worded as to be viewed as inhibiting a potential whistleblower's ability or incentive to report alleged misconduct to the SEC. Although that exercise can prove challenging given the uncertainty around whether broad confidentiality clauses (*i.e.*, prohibiting disclosure to third parties generally) or non-disparagement clauses (*i.e.*, prohibiting employees from making disparaging remarks about the company to third parties generally) would be interpreted by the SEC as violating Rule 21F-17, firms should bear in mind the SEC's general approach in the area and discuss with counsel whether it would be appropriate for existing agreements to be amended to add, and for new agreements to contain, express exclusions from their restrictive covenants for regulatory reporting.

In addition, until the SEC takes some action in this area or provides some concrete guidance, private equity firms and portfolio companies should be cautious about enforcing

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4 Brief for SEC as *Amicus Curiae* Supporting Appellant, *Liu v. Siemens AG*, No. 13-4385 (2d Cir. Feb. 20, 2014), *available at* http://www.sec.gov/litigation/briefs/2014/liu-siemens-0214.pdf; *see also* Sean McKessy, Statement on Court Filing by SEC to Protect Whistleblowers from Retaliation (Feb. 20, 2014) ("Today's filing makes clear that under SEC rules, whisteblowers are entitled to protection regardless of whether they report wrongdoing to their employer or to the Commission.")

5 *See* Debevoise & Plimpton LLP, Client Update: Circuit Court Adopts Narrow Interpretation of Anti-Retaliation Provision of Dodd-Frank Whistleblower Rules (July 19, 2013), *available at* http://www.debevoise.com/clientupdate20130719a.

6 *See, e.g.*, Rachel Louise Ensign, *SEC to Boost Award to First Whistleblower to Recover under Dodd-Frank*, WALL ST. J., Apr. 8, 2014, *available at* http://blogs.wsj.com/law/2014/04/08/sec-to-boost-award-to-first-whistleblower-to-recover-under-dodd-frank.

broadly worded confidentiality or non-disparagement covenants that do not contain an exception for regulatory reporting where there is a chance that (1) the enforcement of those provisions might be viewed as impeding a purported whistleblower's ability to report conduct to the SEC or other regulatory bodies or (2) such action could be viewed as retaliation for suspected or known whistleblowing activities. Firms should consult with legal counsel as appropriate prior to enforcing broadly worded restrictive covenants under such circumstances. In addition, it continues to be a best practice for employers to provide avenues for their employees to report concerns about potential wrongdoing internally with the hope that any potential problem can be addressed promptly.[7]

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Please do not hesitate to contact us with any questions.

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[7] Indeed, some internal reporting is required by SEC Rules. Rule 204A-1 under the Investment Advisers Act of 1940 requires internal reporting of Code of Ethics violations. These Codes of Ethics should not limit, or provide disincentives to, employees that report concerns externally.