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Outside Counsel

Investment Advisers: Beware the Broad Confidentiality Clause

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Investment advisers—hedge fund managers, private equity firms and others—may rely on confidentiality agreements to protect against the disclosure of an investment thesis or algorithm or simply as a means of keeping investors' affairs private. Indeed, Regulation S-P requires registered investment advisers (RIAs) to take steps to "insure the security and confidentiality of customer records and information." However, in light of recent enforcement measures taken by the Securities and Exchange Commission, RIAs should review their confidentiality agreements—including those with investor clients—to make sure these agreements do not violate SEC Rule 21F-17(a), which prohibits the use of confidentiality agreements to deter whistleblowers.

Enforcement Cases

SEC Rule 21F-17(a), adopted in connection with the Dodd-Frank Wall Street Reform and Consumer Protection Act, provides, "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." 17 C.F.R. §240.21F-17(a) (2016). In its three enforcement cases to date, the SEC has made clear that a violation of Rule 21F-17(a) may occur even where a confidentiality provision was not, in fact, used to impede whistleblowers.

In 2015, the SEC brought its first enforcement action under Rule 21F-17(a) against KBR, Inc., a technology and engineering firm that required employees to sign a confidentiality statement that subjected them to discipline if they discussed the particulars of their interview with outside parties without authorization from KBR. KBR settled the action and paid a $130,000 fine. In a press release, the SEC acknowledged KBR had not actually prevented any employees from communicating with the SEC but found the confidentiality statement violated Rule 21F-17(a) because of its "potential chilling effect on whistleblowers' willingness to report illegal conduct to the SEC."[1]

In June 2016, the SEC brought its second case under Rule 21F-17(a) against Merrill, Lynch, Pierce, Fenner & Smith, Inc. Merrill Lynch used an employee severance agreement that prohibited the disclosure of confidential information unless the employee obtained written approval or was compelled by formal legal process. The SEC was "unaware of any instances in which…an employee was in fact prevented from communicating directly with the [SEC]" and unaware of any action by Merrill Lynch to "enforce the form confidentiality agreement to prevent such communications." The SEC nonetheless concluded that Merrill Lynch had violated Rule 21F-17(a) because the agreement "operated to impede" communications with the SEC.[2] Merrill Lynch paid a $358 million fine for this and other violations.

The SEC's most recent enforcement action involving Rule 21F-17(a) concerned severance agreements signed by former employees of BlueLinx Holdings, Inc., a building products company. The SEC published no evidence the agreements actually impeded communications with the SEC but found that BlueLinx had violated Rule 21F-17(a) because its agreements "imped[ed] individuals from communicating directly with [SEC] staff about possible securities law violations."[3] BlueLinx paid a $260,000 fine and agreed to amend its agreements.

Other Agreements

The SEC's Rule 21F-17(a) enforcement actions have focused on confidentiality agreements with employees. But Rule 21F-17(a) is not limited to employees and could also be applied to subscription agreements and investment management agreements that deter investor clients from becoming whistleblowers. Though investors are not vulnerable to adverse employment actions and may be less likely to acquire details of specific wrongdoing, they are more likely to be the victims of securities violations. An investor client who wishes to report a possible violation to the SEC could be deterred by a broad confidentiality provision contained in a subscription agreement, fearing a lawsuit for breach of contract or other adverse action by the investment adviser.

Investor clients of RIAs who become whistleblowers may take comfort that such lawsuits are unlikely to be successful. Section 29(a) of the Exchange Act prohibits the enforcement of any contract that violates any rule promulgated under the Exchange Act, which would include Rule 21F-17(a). 15 U.S.C. §78cc(b) (2012). See also *Woods v. Boeing Co.*, No. 2:11-cv-02855 (RMG), 2013 WL 5332620, at *3 (D.S.C. Sept. 23, 2013), aff'd, (Sept. 30, 2014) (discussing merits of public policy exception to enforcement of confidentiality agreements where a party discloses violations to a federal agency).

But RIAs should be aware that, even if an investor's fear of reprisal is unfounded, the SEC routinely reviews agreements with investor clients when it conducts examinations of RIAs,[4] and the fact that a confidentiality provision could have a "potential chilling effect" may be enough for the SEC to conclude that an agreement violates Rule 21F-17(a).

A confidentiality agreement that restricts broad categories of information is more likely to be found to violate Rule 21F-17(a) than one that is narrow in scope. For example, a confidentiality provision that restricts the disclosure of all information exchanged between an RIA and investor clients is more likely to violate Rule 21F-17(a) than one that restricts

certain categories of information, such as investment advice or trading strategies. And regardless of how broad a confidentiality clause may be, if it expressly exempts disclosures to the SEC, it should not violate Rule 21F-17(a).

RIAs seeking to comply with Rule 21F-17(a) while reducing the risk of confidential information being disseminated to the general public may also consider requiring anyone disclosing information to the SEC to request confidential treatment under SEC Rule 83, which permits the SEC to withhold documents in response to a Freedom of Information Act request.

Conclusion

Like public companies and broker-dealers, investment advisers should ensure their employment agreements and policies do not impede the reporting of securities violations. Moreover, because they regularly incorporate broad confidentiality provisions in agreements with investor clients, investment advisers should take steps to ensure that such agreements do not restrict investors from reporting securities violations to the SEC.

Endnotes:

1. Press Release, Sec. & Exch. Comm'n, SEC: Companies Cannot Stifle Whistleblowers in Confidentiality Agreements (April 1, 2015).

2. Order Instituting Cease and Desist Proceedings ¶¶72, 74, *In re Merrill, Lynch, Pierce, Fenner & Smith*, SEC Exchange Act Release No. 78141 (June 23, 2016).

3. Order Instituting Cease and Desist Proceedings ¶18, *In re BlueLinx Holdings*, SEC Exchange Act Release No. 78528 (Aug. 10, 2016).

4. See 17 C.F.R. §275.204-2(a)(10) (requiring RIAs to "make and keep true, accurate, and current…books and records," including, among other things, "[a]ll written agreements (or copies thereof) entered into by the investment adviser with any client").

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