PUBLICATION

Increased SEC and FINRA Scrutiny on Confidentiality Provisions

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Over the past several months, confidentiality provisions included in settlement agreements, employment or independent contractor contracts, or in other documents, have come under increased scrutiny in the financial industry. In fact, on April 1, 2015, the United States Securities and Exchange Commission (SEC) announced its first enforcement action against a company for using in confidentiality agreements improperly restrictive language that had the potential to stifle the whistleblowing process. A copy of the SEC's announcement is available here. This announcement followed recently-issued guidance from the Financial Industry Regulatory Authority (FINRA), which cautioned firms about the use of confidentiality provisions in settlement agreements, or other documents, that could impede regulatory investigations and the prosecution of enforcement actions. A copy of FINRA's guidance is available here. In light of this guidance, firms must exercise caution when crafting confidentiality provisions, and should routinely assess their confidentiality provisions to ensure compliance with the ever-changing laws and regulations governing the financial industry.

Analyses

Broker-dealer and investment advisory firms regularly establish confidentiality policies or include confidentiality provisions in their employment or independent contractor agreements. These provisions are intended to ensure that registered representatives, who are given access to trade secrets, customer lists, financial accounts and other highly sensitive, confidential information, respect and maintain the confidentiality of this information. Similarly, firms often include confidentiality provisions in settlement agreements or before exchanging documents in arbitration proceedings. Such provisions prohibit the parties from sharing documents received during an arbitration, and often the outcome of the arbitration itself, with "the world." However, the use of such provisions has recently come under intense scrutiny in the financial industry. One particular area of scrutiny relates to the potential such provisions have to impede the whistleblowing process, or to obstruct investigations and prosecutions by regulators. To ensure compliance, firms must carefully craft confidentiality provisions in both settlement agreements and employment or independent contractor contracts to ensure that such provisions do not run afoul of the regulators' concerns.

SEC Guidance:

SEC Rule 21F-17, enacted pursuant to the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, prohibits "any action to impede an individual from communicating directly with the [SEC] staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement." In fact, recently, the SEC's Office of the Whistleblower has repeatedly warned against overbroad confidentiality policies that may be construed to deter an employee from reporting potential misconduct to the SEC.

On April 1, 2015, the SEC announced its first enforcement action against Houston-based KBR, Inc., for using improperly restrictive language in confidentiality agreements that had the potential to stifle the whistleblowing process. KBR used a fairly standard confidentiality provision in connection with internal investigations, which provided that the participating employee was "prohibited from discussing any particulars regarding this interview and the subject matter discussed during the interview, without the prior authorization of the Law

Department" and that "unauthorized disclosure of information may be grounds for disciplinary action up to and including termination of employment."

The SEC instituted "preretaliation" enforcement proceedings against KBR, even though the SEC admitted to not being aware of any instances in which the agreement actually interfered with whistleblowing to the SEC. The SEC argued that such a blanket prohibition against discussing the substance of any interview had a potential chilling effect on employees' willingness to blow the whistle to the SEC.

While KBR did not admit or deny the SEC's findings, the company agreed to settle the charges against it by paying a $130,000 fine and amending its confidentiality provision. KBR's amended confidentiality provision included the following statement:

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 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.

This action against KBR underscores the importance of firms ensuring that employees are given confidentiality instructions that are consistent with the company's legitimate need to protect confidential information, but that do not inadvertently imply that "unauthorized" disclosure of such information to government enforcement agencies will subject an employee to an adverse employment action.

FINRA Guidance:

Addressing similar concerns, 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.

FINRA's guidance made clear that confidentiality provisions cannot be used to prohibit or restrict an individual from initiating communications directly with FINRA or other securities regulators regarding the settlement terms or underlying facts of a dispute, regardless of whether the individual has received an inquiry from such regulatory authority regarding the dispute.

Accordingly, while noting that it was not FINRA's intent to preclude firms from entering into settlement agreements that include acceptable confidentiality provisions, FINRA's guidance mandated that confidentiality provisions in settlement agreements should be written to expressly authorize, without restriction or condition, a customer or other person to initiate direct communications with, or respond to any inquiry from, FINRA or other regulatory authorities.

FINRA's guidance gave the following example of an acceptable confidentiality provision in a settlement agreement:

Any non-disclosure provision in this agreement does not prohibit or restrict you (or your attorney) from initiating communications directly with, or responding to any inquiry from, or providing testimony before, the SEC,

FINRA, any other self-regulatory organization or any other state or federal regulatory authority, regarding this settlement or its underlying facts or circumstances.

This guidance, however, was not limited to confidentiality provisions contained in settlement agreements. FINRA also instructed that any stipulations between parties in an arbitration proceeding, or confidentiality orders issued by an arbitrator as part of the discovery process, regarding the non-disclosure of documents outside the arbitration, must not restrict or prohibit the disclosure of the documents to the SEC, FINRA, any other self-regulatory organization or any other state or federal regulatory authority.

This guidance reflects FINRA's continued efforts to protect whistleblowers. Accordingly, firms should ensure that confidentiality provisions in their settlement agreements and discovery stipulations do not obstruct a party's ability to reach out to regulators concerning potential securities law violations.

Sample Provision:

To ensure compliance with the concerns of both the SEC and FINRA, firms should incorporate language substantially similar to the following in all confidentiality provisions:

Nothing in this confidentiality provision prohibits me from initiating communications directly with, or responding to any inquiry from, or providing testimony before, the 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, the 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 the prior authorization from my firm to make any such reports or disclosures and I am not required to notify the firm that I have made such reports or disclosures.

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 this guidance, firms should routinely assess their confidentiality provisions to ensure compliance with the ever-changing laws and regulations governing the financial industry.

If you have any questions regarding these issues or any other securities-related issues, or need assistance in evaluating your company's policies and procedures, please contact any of the attorneys in Baker Donelson's Broker-Dealer/Registered Investment Adviser group.