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PERSPECTIVE

First-of-its-kind action by the SEC

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On April 1, the Securities and Exchange Commission announced a settlement in connection with a first-of-its-kind enforcement action that sets an alarming precedent for companies seeking to maintain the confidentiality of their internal investigations. The SEC's enforcement action targeted confidentiality agreements used in internal investigations by KBR Inc., a global technology and engineering firm. According to the SEC, the agreements purportedly precluded certain current and former employees from discussing the company's investigations with outside parties absent prior consent from KBR's legal department. The SEC took the position that these common and widely used agreements somehow violate the SEC's whistleblower rules adopted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act.

In connection with the SEC's announcement, the director of enforcement, Andrew J. Ceresney, stated: "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." SEC whistleblower chief Sean McKessy warned companies to "review and amend existing and historical agreements that in word or effect stop their employees from reporting potential violations to the SEC."

The SEC recently took steps to press forward with this agenda. In February, the Wall Street Journal reported that the SEC issued requests to several companies for copies of nondisclosure agreements, employment contracts, and other documents going back several years. Ceresney's comments confirm that the KBR action likely marks only the first in a string of similar enforcement actions that, if permitted to proceed unchecked, may have sweeping implications for companies charged with conducting their own internal investigations in compliance with SEC rules.

Notwithstanding these aggressive SEC actions, it is doubtful that KBR's confidentiality agreements actually violate Dodd Frank. According to the SEC, KBR's confidentiality agreements carried the "potential" to "stifle the whistleblowing process." The SEC claimed the agreements therefore violated SEC Rule 21F-17, which protects the disclosure of securities violations to SEC Staff. The SEC's order requires KBR to pay a $130,000 penalty and to amend its agreements to make clear that its employees could freely report possible securities violations to the SEC without obtaining the company's consent.

But the plain language of the rule makes clear that KBR's confidentiality agreements, standing alone, did not — and indeed could not — amount to a Rule 21F-17 violation. Neither Dodd Frank nor Rule 21F-17 imposes any blanket prohibition on confidentiality agreements, even though commentators questioned this very issue prior to the rule's adoption and the SEC declined to implement such a blanket prohibition. Rather, by its express terms, Rule 21F-17 proscribes "*action*" taken "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." (Emphasis added). Even the most liberal reading of this provision compels the conclusion that the KBR agreements, on their face, do not violate Rule 21F-17.

Photo courtesy of Zaccaro Morgan

Tellingly, in the press release announcing its settlement with KBR, the SEC explicitly conceded that "there are no apparent instances in which KBR specifically prevented employees from communicating with the SEC about specific securities laws violations." And yet, the SEC proceeded with an enforcement action against KBR despite the absence of any evidence that KBR had taken action (or threatened action) to impede anyone from communicating with SEC staff.

Even adopting the SEC's broad construction of Rule 21F-17, KBR's agreements cannot be fairly read to stifle potential whistleblowers with pre-existing knowledge of securities violations. In pertinent part, the agreements merely require witnesses interviewed in internal investigations to acknowledge they are "prohibited from discussing any particulars regarding [the] interview and the subject matter discussed during the interview, without the prior authorization of the Law Department." Like the attorney-client privilege, the agreements on their face preclude only disclosure of the substance of discussions between witnesses and KBR's attorneys. However, the underlying information already in the employee's possession is not rendered privileged or confidential merely by the fact that the employee discussed it with counsel. The confidentiality agreements do not preclude KBR employees from disclosing such information to law enforcement agencies.

Far from impeding whistleblower reporting, KBR's agreements are consistent with best practices and, indeed, are ubiquitous among U.S. corporations. They are designed to further several important objectives, including to ensure that material

SEC enforcement action is ill-founded

nonpublic information is not publicly disseminated, which could constitute a violation of the securities laws, including Regulation FD.

KBR's confidentiality instruction is also necessary to protect attorney-client privilege. This practice flows in part from the U.S. Supreme Court's decision in *Upjohn Co. v. United States*, 449 U.S. 383 (1981), which calls for information obtained in the course of internal investigations to be kept in confidence. Indeed, interpreting the same KBR agreement that the SEC found objectionable, the U.S. Court of Appeals for the D.C. Circuit ruled last year that KBR's internal investigations, and witness interviews in particular, were protected by the attorney-client privilege. See *In re Kellogg Brown & Root, Inc.,* 756 F.3d 754, 760 (D.C. Cir. 2014).

In addition, confidentiality agreements are necessary to protect the integrity of internal investigations. The SEC itself has repeatedly affirmed its own policy of conducting investigations in confidence to protect the integrity of the investigative process, and the reputations of persons or entities involved. This policy implicitly recognizes the important role confidentiality plays in carrying out internal investigations — namely, to prevent witnesses' recollections from being influenced by discussions with other individuals, or the potential for documents or other evidence to be destroyed once word gets out that an investigation is underway. The policy also protects the reputations of the company and individuals if the charges are unwarranted.

If the SEC truly felt these types of agreements are problematic under Rule 21F-17, most companies and law firms that regularly conduct internal investigations likely disagree. Rather than taking an aggressive and ill-founded enforcement action, the SEC could have adopted a more appropriate and practical approach by engaging in rulemaking to address use of confidentiality agreements in internal investigations. Or, particularly given the prevalence of such agreements, the SEC could have clarified its position on Rule 21F-17 by issuing a Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934, just like it did in April 2013 concerning Netflix's social media policy. Pursuing an enforcement action instead and imposing significant penalties smacks more of opportunism against a company unwilling to risk a fight with the SEC rather than principled enforcement policy.

The SEC's enforcement action against KBR is emblematic of its embattled "broken windows" approach to policing securities violations, in which it pursues minor infractions for deterrence purposes and also to achieve easy victories for the Commission. But this strategy comes at the expense of companies' rights and obligations to protect proprietary information and ensure the integrity of internal investigations. The case is a clear example of governmental overreach that should draw scrutiny from SEC insiders and outsiders.

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