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Whistleblowers

Recent SEC Whistleblower Cases Focus on Repressive Language in Employment-Related Agreements

By Robin L. Barton, *Hedge Fund Law Report*

In a matter of weeks, the SEC announced settlements of three enforcement actions involving alleged violations of Rule 21F-17(a) under the Securities Exchange Act of 1934, which 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 . . . with respect to such communications." The SEC's focus in the enforcement actions was on language in employment-related agreements that could deter employees from reporting possible violations. This article summarizes the three cases and then shares insights on their significance from Allison Kernisky, Holland & Knight litigation partner and co-editor of the firm's SECond Opinions blog on SEC enforcement matters, as well as steps fund managers should take to avoid similar SEC scrutiny.

See "SEC and CFTC Received Record Number of Whistleblower Tips and Made a Record Award in 2022" (Feb. 2, 2023).

Summaries of the Three Actions

Private Company: Monolith Resources, LLC

On September 8, 2023, the SEC imposed a $225,000 penalty on Monolith Resources, LLC (Monolith), a privately held company, for Rule 21F-17(a) violations. Between February 2020 and March 2023, Monolith entered into 22 separation agreements that did not limit or bar employees from filing a charge or claim with any federal, state or local agency but did take away their right to recover a monetary award for filing a claim with, or participating in an investigation or action by, a governmental agency.

The SEC found that "the agreements raised impediments to participation in the Commission's whistleblower program by having the employees forego the critically important financial incentives

that are intended to encourage persons to communicate directly with the Commission staff about possible securities law violations." The agency did not, however, find that any former Monolith employees failed to report possible securities violations because of the agreements or that the company enforced those provisions of the agreements. The SEC considered Monolith's remedial actions, which included revising its separation agreements and making reasonable efforts to notify former employees that the agreement did not limit their ability to obtain any incentive award.

Public Company: CBRE, Inc.

On September 19, 2023, the SEC announced its settlement of charges against CBRE, Inc. (CBRE), a real estate services and investment firm that is a subsidiary of the public company CBRE Group, Inc. The order alleged that, since 2011, CBRE entered into separation agreements that required employees to represent they had not filed any complaint or charges against the company with any state/federal court or agency. In 2015, CBRE added a provision to its agreements indicating that nothing in the agreement barred the employee from filing a charge with, or participating in, an investigation or proceeding by the SEC, DOJ, Equal Employment Opportunity Commission or National Labor Relations Board, or comparable federal, state or local agencies. In 2021 and 2022 alone, at least 884 CBRE employees signed such separation agreements.

The SEC found that because the added provision was prospective in application, it did not remedy the impeding effect of the employee representation. The SEC imposed a $375,000 penalty on CBRE despite recognizing that there were no apparent instances in which a former CBRE employee was prevented from communicating with SEC staff about potential securities law violations or in which CBRE took action against a former employee based on the agreement. The SEC did, however, acknowledge CBRE's cooperation and extensive remedial efforts in which it, among other things:

- revised all domestic separation agreements and started an audit of similar agreements worldwide;
- standardized and updated its global policies on compliance with Rule 21F-17;
- created a new Rule 21F-17 "toolkit";
- trained more than 50 members of global compliance teams on the Rule 21F-17 language;
- modified more than 300 agreements and policy templates in 61 countries in more than a dozen different languages; and
- communicated with the more than 800 employees who had signed the prior agreement, advising them of their Rule 21F-17 protections and rights.

Investment Adviser: D.E. Shaw

On September 29, 2023, the SEC settled an action against D.E. Shaw & Co., L.P. (D.E. Shaw), a registered investment adviser and hedge fund manager that, between August 2011 and April 2019, required new hires to sign employment agreements that barred them from disclosing "Confidential Information" to anyone outside of the firm unless authorized by the firm or required by law or an

order of a court or other regulatory or governmental body. Notably, the agreements did not have an exception for voluntary communications with the SEC about possible securities laws violations.

In addition, D.E. Shaw required about 400 departing employees to sign general releases and agreements affirming they had not filed any complaints with any governmental agency, department or official to receive deferred compensation and other benefits. Departing employees who did not execute those documents were provided with exit letters that specified "all provisions of your Employment Agreement . . . shall remain in full force and effect" – including the provision prohibiting disclosure of confidential information unless authorized by the firm or required by law.

Interestingly, in the wake of several prior whistleblower cases, D.E. Shaw notified employees in 2017 that nothing in its employment-related agreements or policies barred them from communicating directly with any regulator about possible violations without disclosure to the firm. Although the firm updated its internal reporting policy, code of ethics and employee handbook accordingly, it did not revise its employment agreements or releases at that time.

See our three-part series on employee handbooks: "Why Every Fund Manager Should Adopt an Employee Handbook" (May 10, 2018); "Ten Key Policies Fund Managers Should Include" (May 17, 2018); and "Ten Common Mistakes Fund Managers Must Avoid" (May 31, 2018).

The SEC found that D.E. Shaw's employment-related agreements and related practices violated Rule 21F-17(a). The Commission also noted that at least one former D.E. Shaw employee was initially discouraged from communicating with the SEC about potential violations due to the provisions discussed above. Although D.E. Shaw revised its release and reached out to former employees who had executed the old documents, the SEC still imposed a $10-million penalty on the firm and censured it.

Enforcement of Rule 21F-17(a)

HFLR: What has been the SEC's approach to enforcing Rule 21F-17(a)?

Kernisky: The SEC takes a broad approach to enforcement, and that approach has been pretty consistent over the years. Sometimes there are settlements that are strictly based on policies or documents the SEC finds the firm has worded wrongly. Sometimes the settlements are based on conduct alone or both policies and conduct. For example, there have been settlements with firms for terminating employees who were whistleblowers. In the recent D.E. Shaw case, the SEC alleged that the firm both discouraged an employee from talking to the SEC and had issues with its documents.

HFLR: It sounds like some of these cases are similar to cases in which, for example, the SEC might say, "We're not claiming anyone in the firm engaged in insider trading, but we are claiming that your insider trading policies are deficient in some way."

Kernisky: Yes. I hesitate to use the phrase "low-hanging fruit," but, for the SEC, these kinds of cases are an easy way to rack up some penalties. The staff can read a separation agreement and say, "We

don't like this provision." If the staff identifies language in a policy, nondisclosure agreement or separation agreement that violates the rule – especially given the rule's age and the history of enforcement messaging around it – it can be very easy for them to highlight the language they don't like and force the firm to correct it.

HFLR: What someone might call a technical violation as opposed to a substantive violation.

Kernisky: Exactly. That's both good and bad. Because it is technical in nature, it's also completely within the firm's control. In the hedge fund world, managers can look at their documents, make corrections to those documents and assess their training fairly simply. It's much harder to police conduct, to know what all your employees are doing and to get someone to stop doing something the SEC would consider violative conduct. So, these kinds of issues are low-hanging fruit on the manager's side as well, because it can take simple steps to make corrections and hopefully avoid coming on the SEC's radar.

SEC Enforcement Actions

HFLR: Within the span of several weeks, the SEC settled the three enforcement actions that all involved provisions of various employment-related agreements that it argued impeded whistleblowers. Was this cluster of cases unusual or surprising?

Kernisky: It wasn't a surprise. Whistleblower protection has been an SEC priority since it was enacted around 2010 as part of the Dodd-Frank Act. The enforcement side is an important part of the SEC's whistleblower program. The Commission's not just saying that it values whistleblowers and rewarding them with what have been some significant awards lately for original information. It's also penalizing organizations that, in the SEC's words, impede whistleblowers or undermine the whistleblower rules. It took a few years to start seeing enforcement actions after the rule was enacted. There have been about 20 or so settlements, including these recent three – and I think that will continue.

HFLR: Are the recent cases consistent with the SEC's prior approach to enforcing Rule 21F-17(a)?

Kernisky: Yes, absolutely. There's nothing in these cases that is unique other than the rare enforcement against a private company and the size of the penalty in the D.E. Shaw case.

Commonalities and Differences

HFLR: Despite the fact that the three cases involved different entities – a registered investment adviser, a public company and a private company – are there parallels or commonalities among them?

Kernisky: There are. It's important to highlight the differences between the types of entities involved. It shows the SEC doesn't discriminate; it's looking at everyone – public companies, private companies, big and small registered advisers.

The commonality across these cases is that, in each one, the entity had a policy or a document the SEC alleged violated Rule 21F-17(a). There are some differences, however, based on the type of language or conduct in question rather than the types of entities involved.

HFLR: What kinds of language or provisions did the SEC find troubling?

Kernisky: It varied. Monolith's agreement essentially said, "You're free to call the SEC, but you can't accept any monetary award for the information that you provide," which I think the SEC interpreted and alleged as effectively telling the employee not to do it because monetary awards are a big incentive for whistleblowing. CBRE's separation agreements required employees to represent that they hadn't filed any complaint against it. In D.E. Shaw's case, its employment agreement said you need authorization from somebody in legal or compliance if you want to talk to the SEC, which, in reality, the SEC seems to have concluded probably was shutting down that person from talking to the government, among other things.

HFLR: Are there other important differences among these three cases?

Kernisky: Yes. Setting aside the penalties for a moment, which we'll come back to, there are some key differences. In Monolith and CBRE, their violative language was in their separation agreements. In D.E. Shaw, it was in both employment agreements and separation agreements. In addition, D.E. Shaw also took action by discouraging an employee from actually reaching out to the SEC, which, in my opinion, had a lot to do with the size of its penalty.

Penalties

HFLR: Let's talk about the penalties because there's a big gap. They range from $225,000 and $375,000 for Monolith and CBRE, respectively, to $10 million for D.E. Shaw.

Kernisky: The penalties are typical, setting aside D.E. Shaw, of course. Penalties in the low six figures are pretty consistent with what you see historically. They do seem to be trending up, however, especially if you include D.E. Shaw. The average now is closer to low seven figures, whereas it was low six figures just a few years ago.

The D.E. Shaw penalties are really interesting. Of the three cases that we're talking about, that firm was censured, but the other two were not. The SEC also found its conduct willful, which isn't a big hurdle but is unique. It was the only case in which the SEC made that finding.

There are a couple of things at play there. First, the SEC alleged that D.E. Shaw did discourage someone from reporting, so its case included claims of both deficient policies and improper action.

Second, the SEC claimed there was asymmetry between what D.E. Shaw told its employees and what its documents said. According to the order, going back to 2010 or 2011, the firm had discouraged employees from talking to the government. In 2017, in response to a slew of earlier SEC settlements in whistleblower cases, it decided to self-correct, which is what you should do and conduct I'd argue the SEC should encourage and reward. It revised its policy and sent out a firmwide email saying essentially, "You can talk to the government. You don't have to ask us in advance. We won't

do anything against you." But the asymmetry the SEC focused on was that it did not revise its actual documents to match its stated policy. It still had language in its onboarding employment agreements and separation agreements that restricted employees from talking to the government.

I think that kind of asymmetry may have chafed the SEC. If you're going to tell your employees something, then your documents had better back that up and match that. I like to tell clients to think of it like matched luggage. If your compliance manual is the gold standard, that's wonderful. But if your employment agreements, separation agreements, releases, training materials, code of conduct, not to mention actual day-to-day practices, etc. don't match the compliance manual and they all don't exist in harmony with each other, then there may be a problem. That kind of thing is easy for the SEC to spot – and it's hard to justify.

Remedial Efforts

HFLR: In each case, the firm made remedial efforts, including D.E. Shaw, but it didn't seem to help them very much. Why not?

Kernisky: D.E. Shaw did remediate – on its own and before the SEC came along, at least initially. It tried to fix what it thought was the problem in 2017, but it just didn't go quite far enough, according to the SEC. It didn't marry its separation agreements and employment agreements with its changed policy. It later revised the employment agreements in 2019 but didn't revise the separation agreements until after the firm was contacted by the SEC. So, D.E. Shaw gave it the old college try. It seems that just wasn't enough for the SEC.

HFLR: Interestingly, D.E. Shaw did exactly what the SEC wants firms to do. That's why it issues press releases when announcing settlements – it wants industry stakeholders to read and learn from them.

Kernisky: Yes, for sure. The lesson here is not, "Why bother?" True, D.E. Shaw tried and still got dinged. But the remedial measures were not for nothing in any of these cases; they did have a positive impact on the outcome. In fact, they were noted by the SEC in each of the releases and orders.

Remedial measures, unfortunately, are not a surefire way to avoid a penalty. Each of these three firms did remediate. CBRE revised more than 300 different forms it had for its separation agreements. It trained more than 100,000 employees in like 50 different countries – and it still was penalized. So, whatever you do to remediate is not a guarantee or even likely going to avoid enforcement altogether or a penalty, but it's most likely going to help with the severity of that penalty and other consequences. It's also just the right thing to do. It demonstrates that you take compliance seriously and want to be proactive, and if there was something that needed to be corrected, you've corrected it and are moving forward.

In some instances, self-reporting is an option if the firm feels like there was something that was fixed or is being fixed and it wants the SEC to know that so it's not later dinged. That's a bit tricky, though, because once you go down that road, you can't go back. You may self-report a discrete issue, and it leads to something else because some document gets produced or somebody says

something – and now you have a much larger issue to deal with. So, that's always a delicate consideration.

[For more on self-reporting, see our two-part series "Why, When and How Fund Managers Should Self-Report Violations to the SEC": Part One (Jan. 10, 2019); and Part Two (Jan. 17, 2019).]

Takeaways for Fund Managers

HFLR: What steps should hedge fund managers take to ensure they don't end up being hit with similar violations and penalties?

Kernisky: There are several steps a firm can take if it needs to shore up itself in this area. The most important in my mind are the documents. If you haven't already, this is a golden opportunity to review your policies, your compliance manual and all of the other documents that we've talked about to ensure they are aligned and compliant with Rule 21F-17(a). One helpful thing the SEC included in the settlement orders was the allegedly violative language and the revised and compliant language. So, you can see real-world examples of what not to do and what language the SEC has said is okay. I encourage everyone to read those orders so you can see exactly what the SEC didn't like and see how it was fixed.

The second piece is employee training, which is just as important. You want to ensure what you're telling employees matches your documents and matches what you need to say under the rule. There may need to be separate or additional training for managers, executives and anyone who will be enforcing the actual policies. The SEC is really interested in tone at the top. If you can say, "We give our executives and managers this training so they understand they're not to discourage anyone from talking to the SEC if they want to," that should go a long way in the SEC's eyes.

[See our two-part series on compliance training: "SEC Expectations and Substantive Traps to Avoid" (Sep. 23, 2021); and "Who Conducts the Training and Five Traps to Avoid When Providing Training" (Sep. 30, 2021).]

The last piece is outreach to former employees. In each of the three settlements, the firms reached out to former employees to say, "We want you to know that if you ever were instructed or told that you weren't allowed to speak freely to the SEC, that you are allowed to talk to them." That shores up all the areas in which the SEC is probably going to look.

HFLR: Should you also document that you did all of those things so if, for example, it comes up in an exam, you can show the examiners that you read those cases, reviewed your documents with them in mind, changed the language (if necessary) and then trained everyone on them?

Kernisky: Yes, absolutely.

HFLR: Any final thoughts?

Kernisky: I don't want companies, hedge funds managers or investment advisers to feel disheartened or discouraged by these settlements. These firms took compliance seriously, tried to do the

right thing, and, in the D.E. Shaw action, still had to pay $10 million. That's kind of discouraging but not without the benefit of increased knowledge going forward. A lot of positive can come from them. They are a blueprint for basically what SEC Enforcement doesn't like and how to identify and address similar issues. Firms would be wise to take these actions to heart and make changes, if necessary.