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House Financial Services Committee Considers Legislation That Would Make SEC Waivers More Difficult to Obtain for Parties Settling with the Commission

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Overview

The House Financial Services Committee is considering draft legislation entitled the "Bad Actor Disqualification Act of 2019" (the "Disqualification Act"), authored by Chairwoman Maxine Waters (D-Calif.), which, if adopted, would create new procedures and establish new standards for the U.S. Securities and Exchange Commission ("SEC" or "Commission") to grant waivers from the automatic disqualification provisions under the federal securities laws.[1] The legislation seeks to address concerns that waivers are too often granted to large financial institutions, which account for the majority of waiver recipients.[2] Under the Disqualification Act, the Commission could grant temporary 180-day waivers upon a showing of "immediate irreparable injury" arising from the disqualification, but any permanent waiver would require notice and comment, as well as a public hearing. In addition, the Commission would not be permitted to consider the costs of a denial of a waiver to the settling party, and the Commission staff would not be permitted to discuss waivers with the settling party.

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Were the Disqualification Act to become law, it would have particularly significant implications for financial institutions and other parties that utilize Rule 506 regularly because they may not be able to obtain waivers from the Bad Actor disqualification. Similarly, financial institutions and issuers may be impaired in obtaining waivers of the Well-Known Seasoned Issuer disqualification. It would also impair the ability of settling parties to have certainty on obtaining waivers before settling, thereby making it less likely that parties will agree to settle enforcement actions short of litigation.

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1 Putting Investors First: Examining Proposals to Strengthen Enforcement Against Securities Law Violators Before the Subcomm. On Investor Protection, Entrepreneurship & Capital Markets of the H. Financial Services Comm., 116th Cong. (2019).

2 *See* Bad Actor Disqualification Act of 2019, Section 2(2).

Waivers from Automatic Disqualifications

The federal securities laws contain a number of automatic disqualification provisions that are triggered by certain types of court injunctions, administrative actions (including settlements), and criminal indictments and convictions. Depending on the triggering event and nature of the violation (which may occur because of the actions of an affiliate), a party may face:

- Ineligibility to rely on status as a well-known seasoned issuer (WKSI);[3]
- Loss of use of the "forward-looking statements" safe harbor;[4]
- Ineligibility to rely on private offering exemptions under Regulation D;[5]
- Ineligibility to rely on offering exemptions under Regulations A and E; or [6]
- Disqualification from receiving a cash solicitation payment from an investment adviser.[7]

Under current practice, disqualified parties, or parties that anticipate being disqualified due to upcoming settlements or judgments, may seek waivers from SEC staff, which typically decides waiver requests under delegated authority from the Commission. The staff has in the past issued guidance on the waiver application process, including what factors it considers when determining whether to grant waivers.[8]

Among the waivers granted by the staff are those resulting from Rule 506(d) "Bad Actor" disqualifications, which were added as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[9] Under the Bad Actor disqualifications, an issuer cannot rely on exemptions from registration under Rule 506 of Regulation D if any of the issuer, the directors or executive officers of the issuer, the twenty-percent beneficial owners, the investment managers (if pooled investment fund issuer), or the solicitors or promoters of the issuer has been subject to certain court injunctions, criminal convictions, regulatory actions involving fraud or bars or suspensions.[10] Disqualification

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3 17 C.F.R. § 230.405.

4 15 U.S.C. § 77z-2(b).

5 17 C.F.R. § 230.506(d)(2)(ii).

6 17 C.F.R. § 230.262, § 230.602

7 17 C.F.R. § 275.206(4)-3(a)(ii).

8 *See, e.g.*, Division of Corporation Finance, SEC, Revised statement on Well-Known Seasoned Issuer Waivers (Apr. 24, 2014), available at: https://www.sec.gov/divisions/corpfin/guidance/wksi-waivers-interp-031214.htm.

9 17 C.F.R. § 230.506(d)(2)(ii).

10 *Id.*

from Rule 506 offerings could significantly impair financial institutions, which regularly participate in such offerings either directly or through their clients, as well as asset management firms that often use Rule 506 to raise investor funds. In considering Bad Actor waiver requests, the Staff has emphasized that "the focus of our analysis will be on how the identified misconduct bears on the applicant's fitness to participate in these exempt offerings."[11]

Conflicting Views About Waivers

Waivers most recently faced significant scrutiny in the Obama administration, as a number of the large financial institutions were resolving enforcement actions stemming from the 2008 financial crisis. At that time, the Commission faced criticism from certain members of Congress about the fact that financial institutions had received repeat waivers.[12] These critics viewed disqualifications as an additional enforcement remedy that should be used by the Commission to punish financial institutions for repeat misconduct.

Certain Commissioners, including former SEC Chair Mary Jo White, drew a distinction between, on the one hand, sanctions for underlying enforcement violations—where considerations of punishment and deterrence are appropriate—and on the other hand, disqualifications and waivers therefrom—which are forward-looking and not intended to be used as supplemental enforcement tools.[13] She suggested that the waiver process should be focused on "determin[ing] whether the entity or individual, going forward, can engage responsibly and lawfully in the activity at issue in the particular disqualification."[14] Then-Commissioner Daniel Gallagher expressed a similar perspective, stating that Congress and the Commission have historically recognized that disqualification provisions were intentionally overbroad and required an exemptive process to offset unintended consequences but that waivers were only appropriate for parties who are unlikely to abuse that relief through future misconduct: "Treating the waiver consideration process like the enforcement sanctioning process effectively, and

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[11] Division of Corporation Finance, SEC, Waivers of Disqualification under Regulation A and Rules 505 and 506 of Regulation D (Mar. 13, 2015), *available at* https://www.sec.gov/divisions/corpfin/guidance/disqualification-waivers.shtml (concerning factors for Bad Actor waivers).

[12] Letter from U.S. Senator Elizabeth Warren to Chair Mary Jo White, SEC (June 2, 2015), *available at* http://www.warren.senate.gov/files/documents/2015-6-2_Warren_letter_to_SEC.pdf.

[13] Mary Jo White, Chair, SEC, Remarks at the Corporate Counsel Institute, Georgetown University: Understanding Disqualifications, Exemptions and Waivers Under the Federal Securities Laws (Mar. 12, 2015), https://www.sec.gov/news/speech/031215-spch-cmjw.html

[14] *Id.*

inappropriately, conflates automatic disqualifications with remedial and punitive sanctions."[15]

Other Commissioners have dissented when the Commission has voted to grant waivers, arguing that the Commission should not grant waivers to institutions that have engaged in repeat violations.[16] Certain Commissioners have also advocated for a nonbinary approach to waivers, in particular, the use of conditional waivers.[17] Conditional waivers would permit parties to avoid disqualification so long as they abide by certain conditions of a settlement and face no further enforcement action against them in a given time period. Notably, this flexible approach would not be permitted under the Disqualification Act.

Current SEC Chair Jay Clayton has not spoken publicly on the issue, but during his tenure the Commission and the Commission staff have continued to grant waivers with regularity.

The Proposed Legislation

The Disqualification Act would change the current application process from one primarily handled by SEC staff to one with statutorily mandated procedures that require action by the Commission after public deliberation.

First, the Disqualification Act would create a temporary waiver process. That process would require applicants to petition the Commission for a single 180-day waiver, which the Commission (not the staff) may grant if the applicant demonstrates "immediate irreparable injury."[18] In addition, the Commission would have to publish the petition, as well as the order granting the waiver.

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15 Daniel M. Gallagher, Comm'r, SEC, Remarks at the 37th Annual Conference on Securities Regulation and Business Law: Why is the SEC Wavering on Waivers? (Feb. 13, 2015), https://www.sec.gov/news/speech/021315-spc-cdmg.html.

16 *See*, *e.g.*, Kara M. Stein, Comm'r, SEC, Dissenting Statement in the Matter of Deutsche Bank AG, Regarding WKSI (May 4, 2015), https://www.sec.gov/news/statement/dissenting-statement-deutsche-bank-ag-wksi.html.

17 *See*, *e.g.*, Kara M. Stein, Comm'r, SEC, Statement in the Matter of JP Morgan Chase Bank, N.A., Regarding Order Under Rule 506(d) of the Securities Act of 1933 Granting a Waiver of the Rule 506(d)(1)(iii) Disqualification Provision (Dec. 18, 2015), https://www.sec.gov/news/statement/statement-on-jpmorgan-chase-bank-12-18-2015.html; Luis A. Aguilar, SEC, Public Statement: Enhancing the Commission's Waiver Process (Aug. 27, 2015), https://www.sec.gov/news/statement/aguilar-enhancing-commissions-waiver-process.html; Mary Jo White, Chair, SEC, Remarks at the Corporate Counsel Institute, *supra* note 13.

18 Disqualification Act, Sec. 3(1)(A).

Second, the Disqualification Act would require a public notice and public hearing on any application for a permanent waiver.[19] This is a significant departure from current practice and from Commission action generally, which handles matters such as waivers in closed session at the same time the enforcement action is authorized.

Third, the Commission alone would be authorized to grant a waiver and could only do so if it determines that the waiver "(i) is in the public interest; (ii) is necessary for the protection of investors; and (iii) promotes market integrity."[20] The Commission could not consider direct costs arising from the disqualification in the waiver determination. The legislation would further remove the SEC staff from the role the staff currently plays by expressly prohibiting the staff from providing information on the likelihood of a waiver being granted or denied.[21]

Finally, the Commission would be required to establish and maintain a database of all "ineligible persons," i.e., those persons who had automatic disqualifications and whose waiver requests the Commission had determined not to approve. [22]

Implications of the Disqualification Act

Were the Disqualification Act to become law, it would have dramatic implications both for the Commission and for the entities and individuals within the SEC's jurisdiction.

First, the Act would drastically alter the process by which the Commission and SEC staff deliberate on and administer the granting of waivers. At present, settling parties interact with the staff and receive information prior to the Commission approving a settlement that a waiver will be granted (or not). The Act would preclude the staff from engaging in those discussions. Deprived of the critical information about the likelihood of receiving a waiver, parties would have no way of knowing the actual consequences of the settlement and would thereby be less likely to settle given the consequences of disqualification.

Second, the Act would only allow for temporary waivers upon a showing of "immediate irreparable injury." Depending upon how that standard is interpreted by the Commission, large financial institutions and issuers could have difficulty satisfying that standard, meaning that a waiver may not be available at the time of settlement. This

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19 *Id.* at Sec. 3(1)(C).

20 *Id.* at Sec. 3(1)(B).

21 *Id.* at Sec. 3(1)(D).

22 *Id.* at Sec. 3(2).

likewise means that parties would be less likely to settle if they do not have certainty regarding a potential waiver.

Third, obtaining a permanent waiver would require notice and comment and a public hearing. It is likely that, in that context, the conduct at issue in the settlement—which the settling party has sought to put behind it—would be rehashed and the Commissioners could be pressured to deny a waiver as an additional remedial action. Moving the determinations of waivers to a public hearing may well introduce political considerations to already complicated regulatory deliberations.

Fourth, the costs to the entity arising from the disqualification cannot be taken into account in determining whether to grant a waiver. The impact of a denial of a waiver is typically one of the factors that the staff considers in addressing waivers,[23] and the inability to consider that factor—which often weighs in favor of a waiver, particularly for entities that have active involvement in Rule 506 offerings or utilize the WKSI shelf frequently—removes an important consideration in the waiver process.

For major financial institutions and any registered entity that relies heavily on Regulation D, the resulting inability to obtain a waiver could have profound and, in certain cases, catastrophic consequences. As the triggering event for a 506(d) disqualification often stems from actions by individuals completely unrelated to the Regulation D offerings—especially at complex financial institutions with tens of thousands of employees—such a result transforms disqualifications into additional enforcement remedies and seems beyond what is required to protect investors and ensure market integrity.

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Please do not hesitate to contact us with any questions.

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[23] *See supra* note 9 (concerning factors for WKSI waivers); Division of Corporation Finance, SEC, Waivers of Disqualification under Regulation A and Rules 505 and 506 of Regulation D (Mar. 13, 2015), available at https://www.sec.gov/divisions/corpfin/guidance/disqualification-waivers.shtml (concerning factors for Bad Actor waivers).

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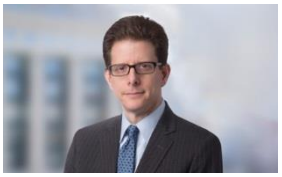
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