

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

June 14, 2019

Memorandum

To: Members, Committee on Financial Services

From: FSC Majority Staff

Subject: June 19, 2019, hearing entitled “Putting Investors First: Examining Proposals to Strengthen Enforcement Against Securities Law Violators”

On Wednesday, June 19, 2019 at 2:00 p.m., the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, “Putting Investors First: Examining Proposals to Strengthen Enforcement Against Securities Law Violators.” Witnesses for the hearing are:

- **Jordan A. Thomas**, Partner, Labaton Sucharow
- **Urska Velikonja**, Professor of Law, Georgetown University Law Center
- **Andrew N. Vollmer**, Professor of Law, University of Virginia School of Law
- **Stephen Crimmins**, Partner, Murphy & McGonigle PC

This hearing will examine eight legislative proposals that are designed to bolster regulators’ enforcement tools against securities law violators.

Background

The Securities and Exchange Commission (SEC) is responsible for prosecuting violations of the securities laws and holding violators accountable in cases involving everything from corporate disclosure violations to fraudulent sales of complex financial products. In civil enforcement actions before a court, the SEC may seek injunctions to prohibit further violations, civil monetary penalties, or the return of illegal profits (called disgorgement). A court may also bar or suspend an individual from serving as a corporate officer or director. Similarly, in administrative actions, the SEC may seek cease and desist orders, suspension or revocation of broker-dealer and investment advisor registrations, censures, bars from association with the securities industry, civil monetary penalties, and disgorgement.

Separately, the SEC oversees the Public Company Accounting Oversight Board (PCAOB), a self-regulatory organization and the principal regulator overseeing accounting firms that audit public companies and SEC-registered brokers and dealers. The PCAOB has the authority to bring disciplinary action against these firms for noncompliance with the Sarbanes-Oxley Act of 2002,

or SEC and PCAOB rules.¹ In these disciplinary actions, the PCAOB may impose a censure, monetary penalties, revocation of a firm's registration, and bar an individual's association with registered accounting firms. However, the Sarbanes-Oxley Act requires the PCAOB to keep its investigations and disciplinary proceedings confidential at least until the case is appealed to the SEC, the SEC elects on its own to review the Board's final decision, or the opportunity for SEC review has passed.

1. H.R. ____, Holding Foreign Companies Accountable Act (Sherman)

The PCAOB must inspect both U.S. and non-U.S. auditors that audit U.S. public companies. However, the positions of certain foreign authorities prevent or significantly impair the PCAOB's ability to inspect non-U.S. audit firms.² Specifically, the PCAOB faces obstacles in inspecting the principal auditor's work of 224 U.S.-listed companies (with \$1.8 trillion in combined market capitalization). There are another 207 U.S.-listed companies where the PCAOB can inspect some—although not all—of the auditor's work.³ While many countries have cooperative agreements or simply cooperate with the PCAOB, the Chinese government has long prevented the PCAOB from inspecting auditors in China and Hong Kong.⁴

The draft bill would require the SEC to prohibit U.S. public companies from trading on an exchange or an alternative trading system if: 1) the firm is inspected annually and it retains a foreign public accounting firm that the PCAOB is unable to inspect for 3 consecutive years; or 2) the firm is inspected once every three years and it retains a foreign public accounting firm that the PCAOB is unable to inspect for 6 consecutive years. The SEC can end the trading prohibition once the company certifies that it has retained a public accounting firm that the PCAOB is able to inspect. The draft bill would also require an issuer to disclose whether it is state-owned or government-controlled.

2. H.R. ____, Stronger Enforcement of Civil Penalties Act of 2019 (Porter)

The draft bill would increase the SEC's statutory limits on civil monetary penalties; directly link the size of these penalties to the scope of harm and associated investor losses; and substantially raise the financial stakes for repeat securities law violators. Specifically, the draft bill would increase the per-violation cap applicable to the most serious securities laws violations from \$181,071 to \$1 million per violation for individuals, and from \$905,353 to \$10 million per violation for entities. It would also triple the penalty cap for recidivists who have been held

¹ Enforcement, Public Company Accounting Oversight Board (last accessed May 22, 2019) (available at <https://pcaobus.org/Enforcement/Pages/default.aspx>).

² Chairman William D. Duhnke III, Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China (Dec. 7, 2018) (available at https://pcaobus.org/News/Speech/Pages/statement-vital-role-audit-quality-regulatory-access-audit-information-internationally.aspx#_ftn9).

³ *Id.*

⁴ Issuers that are Audit Clients of PCAOB-Registered Firms From Non-U.S. Jurisdictions where the PCAOB is Denied Access to Conduct Inspections (last accessed May 22, 2019) (available at <https://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx>)

criminally or civilly liable for securities fraud within the preceding five years. The SEC would be able to assess these types of penalties through administrative action, and not just in federal court.

This increased authority is consistent with that requested by former SEC Chair Schapiro and agreed to by former SEC Chair White.⁵ This bill is similar to a bipartisan bill in the Senate (S.779) and a modest increase to a provision in former Chairman Hensarling's CHOICE Act from the 115th Congress (Section 211 of H.R. 10).

3. H.R. ____, To establish a whistleblower program at the Public Company Accounting Oversight Board (S. Garcia)

The draft bill would establish a whistleblower program at the PCAOB, that is similar to the program Congress established at the SEC under the Dodd-Frank Act. If eligible for a reward upon the successful completion of a PCAOB disciplinary action, whistleblowers may be incentivized to come forward when they suspect violations of the Sarbanes-Oxley Act, the rules of the PCAOB and the SEC, and other laws, rules, and professional standards governing the audits of public companies, brokers, and dealers. These whistleblowers would also be protected from retaliation by their employer.

4. H.R. ____, PCAOB Enforcement Transparency Act of 2019 (Pressley)

The draft bill will make PCAOB hearings and all related notices, orders, and motions, open and available to the public unless otherwise ordered by the Board. The PCAOB procedure would then be similar to SEC Rules of Practice⁶ for similar matters, where hearings and related notices, orders, and motions are open and available to the public. This draft bill is similar to a bipartisan bill in the Senate (S. 1256), as well as, a House bill from the 114th Congress that was sponsored by former Republican Representative Scott Garrett (HR. 6251).

5. H.R. ____, To amend the Securities Exchange Act of 1934 to allow the Securities and Exchange Commission to seek and Federal courts to grant restitution to investors and disgorgement of unjust enrichment (McAdams)

The draft bill would clarify that the SEC may obtain the following equitable remedies that are not subject to a statute of limitations: (1) restitution to investors in amounts equal to the amount of loss to investors; (2) disgorgement in the amount of any unjust enrichment obtained by the defendant; and (3) injunctions, including officer and director bars.

This draft bill would overturn a recent Supreme Court case, *Kokesh v. SEC*, which held that disgorgement is a penalty and therefore subject to a five-year statute of limitations.⁷ As a result of that case, the SEC may only bring cases for disgorgement within five years of the date of the violation, regardless of whether the SEC was able to detect it within five years of the

⁵ Letter from SEC Chairman Mary Schapiro to Senator Jack Reed re: SEC Penalty Authority (Nov. 28, 2011), available at <http://www.davispolk.com/files/uploads/IMG/Mary-Schapiro--Letter-to-Senator-Jack-Reed.pdf>

⁶ 17 C.F.R. 201

⁷ *Kokesh v. SEC*, 581 U.S. (2017).

violation. According to the SEC, the case has cost investors over \$800 million by limiting the time the SEC has to recover funds.⁸

6. H.R. ___, Corporate Management Accountability Act of 2019 (Porter)

This draft bill would require publicly traded companies to disclose their policies on whether senior executives or shareholders bear the costs of paying the company’s fines and penalties. Over the past year, the SEC has focused its efforts on individual accountability. According to the SEC, “Institutions act only through their employees, and holding culpable individuals responsible for wrongdoing is essential to achieving our goals of general and specific deterrence and protecting investors by removing bad actors from our markets.”⁹ In FY 2018, the SEC charged individuals in more than 70% of the standalone enforcement actions it brought.¹⁰ This draft bill is similar to a Senate bill from last Congress (S. 1912).

7. H.R. ___, To establish a statute of limitations for certain actions of the Securities and Exchange Commission (Gonzalez)

The draft bill would address a Supreme Court case, *Gabelli v. SEC*, which held that the SEC has a five-year limit, or statute of limitations, to seek a civil penalty against a defendant and that the five-year limit begins at the date the violation occurs, not the date the SEC discovered it.¹¹ Specifically, the bill would provide the SEC with a 10-year statute of limitations for civil monetary penalties, which would begin on the date at which the violation occurred.

This draft bill is similar to a bill in the Senate from the 114th Congress (S. 1960).

8. H.R. ___, Bad Actor Disqualification Act of 2019 (Waters)

The SEC and Congress have adopted numerous disqualification provisions, which prevent “bad actors” from using one or more provisions in the securities laws that allow certain companies to engage in activities with less oversight and public disclosure or limited liability. These disqualification provisions are triggered by certain enforcement actions, such as criminal convictions for certain felonies and misdemeanors and violations of the anti-fraud provisions of securities laws.¹² Under the securities laws, the Commission has the authority to waive disqualification in appropriate instances.¹³

⁸ Dave Michaels, Supreme Court 2017 Decision Has Cost Investors Over \$800 Million, SEC Says, *The Wall Street Journal* (May 16, 2018), available at <https://www.wsj.com/articles/supreme-court-2017-decision-has-cost-investors-over-800-million-sec-says-1526487555>,

⁹ 2018 Annual Report, Division of Enforcement, Securities and Exchange Commission, available at <https://www.sec.gov/files/enforcement-annual-report-2018.pdf>.

¹⁰ *Id.*

¹¹ *Gabelli v. SEC*, 568 U.S. 442 (2013)

¹² According to the SEC “The disqualification provisions of Rule 506 were intended to and should lead to enhanced investor protection by reducing the number of offering participants who have previously engaged in fraudulent activities or who previously violated securities, insurance, banking or credit union laws or regulations, and by providing an additional deterrent to future fraudulent activities.” Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings, 78 FR 44730 at 44762 (July 24, 2013) <http://www.gpo.gov/fdsys/pkg/FR2013-07-24/pdf/2013-16983.pdf>

¹³ For example, 17 C.F.R. § 230.262(b) allows the Commission to waive Regulation A disqualifications upon a showing of good cause that the disqualification is not necessary under the circumstances

Historically, the waiver process at the SEC has been delegated to staff lawyers in the Divisions of Corporation Finance or Investment Management who review waiver applications by bad actors facing disqualification. Staff's determination to issue a waiver is posted to the SEC's website without public input. There is no public account of waiver requests denied by the SEC or disqualifications where no waiver is sought.

In 2014, former SEC Commissioner Kara Stein objected to this process in the case against the Royal Bank of Scotland Group (RBS), whose subsidiary was criminally convicted for a four-year scheme of manipulating the London Interbank Offered Rate (LIBOR), a widely used benchmark for short-term interest rates.¹⁴ Absent a waiver, the criminal conviction would have automatically precluded RBS from eligibility as a Well-Known Seasoned Issuer ("WKSI"), a status that confers communication and securities registration flexibility.¹⁵ In dissenting from the order granting the waiver, Commissioner Stein stated that the SEC has a practice of "almost reflexively granting waivers of all types, and most often to large financial institutions."¹⁶

Since the category of WKSI as part of the Securities Offering Reform initiative was created in 2006, the SEC has granted 134 WKSI waivers. In addition, since 2003, the Commission has granted 162 waivers of the disqualifications under Regulations A and D, 57 of which were granted after the SEC adopted the Rule 506 disqualification and waiver provisions in September 2013.

The draft bill would amend the current waiver process at the SEC by requiring the agency to:

- elevate the process and votes to the Commission level, rather than at the staff level;
- consider whether granting a waiver would be in the public interest, protect investors, and promote market integrity;
- publish notice and afford the public an opportunity to comment and present their views at a public hearing on whether a particular waiver should be granted or denied;¹⁷ and
- keep complete, public records of all waiver requests (formal and informal) and create a public database of all disqualified bad actors.

¹⁴ Commissioner Kara M. Stein, Dissenting Statement in the Matter of The Royal Bank of Scotland Group, PLC, Regarding Order Under Rule 405 of the Securities Act of 1933, Granting a Waiver From Being an Ineligible Issuer (Apr. 28, 2014), available at <https://www.sec.gov/news/public-statement/2014-spch042814kms>.

¹⁵ Commissioner Kara M. Stein, Dissenting Statement in the Matter of The Royal Bank of Scotland Group, PLC, Regarding Order Under Rule 405 of the Securities Act of 1933, Granting a Waiver From Being an Ineligible Issuer (Apr. 28, 2014), available at <https://www.sec.gov/news/public-statement/2014-spch042814kms>.

¹⁶ *Id.*

¹⁷ This public process is similar to the waiver process for the Department of Labor, which was utilized in 2014 in the case of Credit Suisse which, as a result of its conviction for tax evasion, was disqualified from the beneficial status of Qualified Professional Asset Manager. See DOL, US Department of Labor announces public hearing on Credit Suisse (Nov. 14, 2014), <https://www.dol.gov/opa/media/press/ebsa/EBSA20142115.htm>.