The Bad Actor Disqualification Act

The Bad Actor Disqualification Act of 2015 would ensure that the SEC is honoring the intent of existing bad actor disqualification provisions in securities laws by increasing the accountability of, and requiring the Securities and Exchange Commission (SEC) to, implement a more rigorous, fair, and public process for waiving these disqualifications. In particular, it would:

- Require the waiver process to be conducted and voted on at the Commission level, rather than the staff level;
- Require the Commission to consider whether granting a waiver would be in the public interest, protective of investors, and promote market integrity;
- Provide the public a notice and comment period and the opportunity to request a hearing on whether a particular waiver should be granted or denied;[1] and
- Require SEC staff to keep complete, public records of all waiver requests and denials (formal and informal) and create a public database of all bad actors.

Background

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 law-abiding companies to engage in activities with less oversight and public disclosure or limited liability. The Commission also has the authority, in appropriate instances, to waive these disqualifications. However, the SEC has granted waivers on a seemingly automatic basis and done so disproportionately for large financial firms, leading to the public perception that these institutions are "too-big-to-bar."

The nine disqualification provisions in the securities laws are important tools that protect investors, the markets, and the public by deterring misconduct, reducing recidivism, promoting market integrity, and removing bad actors from the

[1] This public process is similar to the waiver process for the Department of Labor, which was recently utilized 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.

market.[2] They are triggered by certain enforcement actions, such as criminal convictions for certain felonies and misdemeanors and violations of the anti-fraud provisions of the securities laws, which reflect poorly on the integrity of the bad actor and its ability to follow the law.

Current SEC Waiver Process and Need for Legislation

Historically, the waiver process at the SEC has been delegated to staff lawyers in the Division of Corporation Finance or the Division of Investment Management who, after reviewing waiver applications by bad actors before they became disqualified, found good cause for granting waivers with little to no justification and no public input.[3] These waivers are then posted to the SEC's website. There is no public account of waiver requests denied by the Commission. Information regarding waiver applications that are submitted but withdrawn, waiver denials, and disqualifications where no waiver is sought have not been made public, and the SEC does not keep a complete record of this information.

In August 2014, SEC Commissioner Stein objected to this process in the case of The Royal Bank of Scotland Group (RBS), whose subsidiary was criminally convicted for its conduct in manipulating the London Interbank Offered Rate (LIBOR). As a consequence, the Commission held a vote and ultimately approved the waiver, notwithstanding the public dissent of Commissioner Stein in which she stated that the SEC has established a practice of "almost reflexively granting waivers of all types, and most often to large financial institutions."[4] Since then, the Commission has elevated some of the waiver decisions to a Commission vote. In addition, Chair White directed staff in September 2013 and January 2014 to keep track of informal waiver requests for Rule 506 and Well-Known Seasoned

---

[2] As stated by the SEC, when implementing the Rule 506 disqualification and waiver provision in September 2013, "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." *See* 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/FR-2013-07-24/pdf/2013-16983.pdf (citing Statement of Senator Christopher Dodd, 156 Cong. Rec. S3813 (daily ed. May 17, 2010))

[3] The waiver process under Section 9(c) of the Investment Company Act varies slightly, with a different standard for approval and some additional transparency measures.

[4] http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541670244#.VQboUvnF98E

Issuer (WKSI) disqualifications, respectively.[5] Staff has also recently revised its 2011 written guidance on WKSI waivers[6] and published new guidance on Regulations A[7] and D waivers.[8]

Despite these recent improvements to the waiver process, more remains to be done to ensure that the SEC does not "reflexively" throw away these disqualification tools or enshrine a policy of "too-big-too-bar." Authority to grant waivers remains delegated to SEC staff attorneys, with the Commissioners able to conduct a post-approval review and affirm, reverse, modify, set aside, or remand for further proceedings. There is no opportunity for pre-determination public notice, comment, or a hearing so that interested parties can express their concerns about granting or denying a waiver in a particular case. The staff recordkeeping on informal waiver requests is limited to certain disqualifications, incomplete, and nonpublic—allowing perhaps some of the worst bad actors to avoid public scrutiny and leaving investors and others that may conduct business with the bad actors in the dark about their misconduct and disqualifications. And, while the WKSI and Regulations A and D guidance are a step in the right direction of providing transparency to bad actors and the public, neither was subject to a notice-and-comment process and both appear to omit important considerations, such as the recidivist history of the wrongdoer. What's more, it appears that the good cause legal standard for waiver approval is amorphous and does not ensure that the Commission makes appropriate findings about any impact on the public, investors, and market integrity.

Without the necessary transparency and accountability by the Commission, investors, companies, and the public are left wondering about the fairness of the process, the utility of the disqualification provisions, and the continued presence of bad actors in the marketplace. Indeed, it appears that waivers of the disqualifications in the securities laws are routine.

For example, since 2006, when the category of WKSIs as part of the Securities Offering Reform initiative was first created, the SEC has granted 80

---

[5] Rule 506 allows companies to raise money via private offerings that provide fewer disclosures to investors. WKSI status allows companies (generally large companies that are household names) to offer shares to the public without the SEC staff's prior review.

[6] *See Revised Statement on Well-Known Seasoned Issuers* (April 24, 2014), *available at*http://www.sec.gov/divisions/corpfin/guidance/wksi-waivers-interp-031214.htm.

[7] Regulation A allows for small public offerings of securities with more limited disclosure requirements.

WKSI waivers. In addition, since 2003, the Commission has granted 118 waivers of the disqualifications under Regulations A and D, thirteen of which were granted after the SEC adopted the Rule 506 disqualification and waiver provisions in September 2013.

Based on the scant public information, the bad actor disqualifications are underutilized and waivers are disproportionately granted to the large financial firms. According to one study of WKSI and Regulations A and D waivers between July 2003 and December 2014, large financial firms received 164 out of 201 waivers or 82%, the vast majority of waivers.[9] Many of these large financial firms are also recidivists, for which the SEC grants waivers in multiple enforcement actions. Indeed, of those firms with multiple enforcement actions resulting in waivers, large financial firms received 83%. As recognized by Commissioner Stein, "One large financial firm alone, in a 10 year period, has received over 22 different waivers — often making the argument that it has a 'strong record of compliance with federal securities laws.'"[10]

Disproportionately providing large financial firms, especially recidivists, with waivers is, on its face, troubling. According to Commissioner Stein, while these large financial firms are vast operations with multiple business lines and thousands of employees making disqualifications statistically more likely, "their size and complexity should not insulate them from the same regulatory consequences that other issuers must bear."[11] It is inappropriate and unfair for large financial firms to use their corporate structure as a shield from these disqualifications and sends the message that some firms are indeed too-big-to-bar.

---

[9] Professor Urska Velikonja, Emory University School of Law, Waiving Disqualification: When Do Securities Law Violators Receive a Reprieve?, Working Paper, available at http://papers.ssrn.com/abstract=2563726.
[10] http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541670244#_ftnref4
[11] http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541670244#.VQcPZvnF98F