FINANCIAL SERVICES COMMITTEE DEMOCRATS

SUMMARY: THE BAD ACTOR DISQUALIFICATION ACT

The Bad Actor Disqualification Act of 2017 would ensure that the Securities and Exchange Commission (SEC) honors the intent of automatic disqualification provisions in securities laws that prohibit "bad actors" from participating in market activities reserved for law abiding companies. It would do so by requiring the SEC to implement a rigorous, fair, and public process for waiving these disqualifications. Specifically, it would:

- Require the waiver process to be conducted and voted on at the Commission level, rather than at the staff level;
- Require the Commission to consider whether granting a waiver would be in the public interest, protect investors, and promote market integrity;
- Require the Commission to 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;[1] and
- Require SEC staff to keep complete, public records of all waiver requests (formal and informal) and create a public database of all disqualified 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. 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 the securities laws, which reflect poorly on the integrity of the bad actor and its ability to follow the law. Disqualification is an important tool for protecting investors, the markets, and the public by deterring misconduct, reducing recidivism, promoting market integrity, and removing bad actors from the marketplace.[2]

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[1] 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.

[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))

Under the securities laws, the Commission has the authority to waive disqualification in appropriate instances.[3] However, the SEC has granted waivers on a seemingly automatic basis and has done so disproportionately for large financial firms, leading to the public perception that such institutions may be "too-big-to-bar."

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 review waiver applications by bad actors facing disqualification. Staff's determination to issue a waiver in a particular case, purportedly after the bad actor showed good cause that disqualification is unnecessary, is posted to the SEC's website with little to no stated justification and no public input.[4] There is no public account of waiver requests denied by the Commission or disqualifications where no waiver is sought, and the SEC is not presently required to maintain internal records of this information.

In April 2014, SEC Commissioner Kara M. Stein objected to this process in the case of 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. Absent a waiver from the SEC, 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. The Commission ultimately approved the waiver by a split vote and published its determination with little to no justification in a 2-page order.[5] In dissenting from that order, Commissioner Stein stated that the SEC has established a practice of "almost reflexively granting waivers of all types, and most often to large financial institutions."[6]

The Commission has since elevated other waiver decisions to a Commission vote. In addition, former Chair Mary Jo White directed staff in September 2013 and January 2014 to keep track of informal waiver requests for Rule 506 and Well-Known Seasoned Issuer (WKSI) disqualifications, respectively.[7] The SEC's Division of Corporation Finance has also recently revised its 2011 written guidance on WKSI waivers[8] and published new guidance on Regulations A[9] and D[10] waivers.[11]

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 public notice, comment, or a hearing prior to a waiver determination. Interested parties are thus unable to express their concerns about whether a waiver should be granted or denied in a particular case. Further, SEC

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[3] 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.
[4] 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.
[5] In the Matter of The Royal Bank of Scotland Group, PLC, Exchange Act Release No. 72032 (Apr. 25, 2014), *available at* https://www.sec.gov/rules/other/2014/33-9578.pdf
[6] http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541670244#.VQboUvnF98E
[7] 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.
[8] *See* SEC, Division of Corporation Finance, *Revised Statement on Well-Known Seasoned Issuers* (Apr. 24, 2014), *available at*http://www.sec.gov/divisions/corpfin/guidance/wksi-waivers-interp-031214.htm.
[9] Regulation A allows companies to offer public securities with more limited disclosure requirements than registered public securities.
[10] Regulation D allows companies to offer securities privately to sophisticated investors without having to register those securities with the SEC.
[11] SEC, Division of Corporation Finance, *Waivers of Disqualification under Regulation A and Rules 505 and 506 of Regulation D* (Mar. 2015), *available at* https://www.sec.gov/divisions/corpfin/guidance/disqualification-waivers.shtml.

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 other interested parties in the dark about disqualifications. Finally, 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 increased transparency regarding waivers, 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.

Recent Waiver Statistics

Recent history demonstrates that the SEC routinely grants disqualification waivers. For example, since the category of WKSIs as part of the Securities Offering Reform initiative was created in 2006, the SEC has granted 112 WKSI waivers. In addition, since 2003, the Commission has granted 147 waivers of the disqualifications under Regulations A and D, 42 of which were granted after the SEC adopted the Rule 506 disqualification and waiver provisions in September 2013.[12]

Based on the scant public information, bad actor disqualifications are underutilized and waivers are disproportionately granted to the largest financial firms. According to one study of WKSI and Regulations A and D waivers between July 2003 and December 2014, the SEC granted the vast majority of waivers (164 out of 201 waivers, or 82%), to large financial firms.[13] Many of these firms are also recidivists that have received waivers in multiple enforcement actions. Indeed, large financial firms have received 83% of the waivers that the SEC has granted to institutions with multiple enforcement actions resulting in waivers.[14] 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.'"[15]

The SEC's pattern of disproportionately granting waivers to large financial firms, including recidivists, is troubling on its face. While vast operations with multiple business lines and thousands of employees make disqualifications statistically more likely at large firms, "their size and complexity should not insulate them from the same regulatory consequences that other issuers must bear."[16] 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.

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[12] The SEC has granted an additional 32 WKSI waivers and 72 bad actor waivers through the Municipalities Continuing Disclosure Cooperation (MCDC) initiative, which, in 2014, offered favorable settlement terms to issuers and others involved in the offer or sale of municipal securities if they self-reported possible prior violations of Rule 15c2-12 under the Securities Exchange Act of 1934 for materially inaccurate statements with their continuing disclosure obligations.

[13] 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.

[14] *Id.*

[15] http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541670244#_ftnref4

[16] http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541670244#.VQcPZvnF98F