Representative Waters Releases Discussion Draft for SEC Waiver Process Reform

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House Financial Services Committee Chairwoman Maxine Waters (D-CA) has released a discussion draft of legislation to amend the SEC's approach to considering and granting waivers to automatic bad actor disqualifications. If adopted, the draft legislation, entitled the "Bad Actor Disqualification Act of 2019" (the "Draft Bill"), would, among other things, introduce a 180-day temporary waiver period, require a notice and comment period for all waiver applications, and prohibit SEC Staff from providing applicants with advice as to whether a waiver is likely to be granted. The Draft Bill could make it significantly more difficult to reach settlements where the contemplated violation would trigger disqualification because it eliminates the certainty regarding collateral consequences on which settling parties typically place a premium. This may result in an increased number of SEC enforcement cases that must be resolved through litigation.

The Automatic Disqualification and Waiver Process

The federal securities laws include a number of automatic disqualifications that prevent parties from relying on provisions of the securities laws that offer flexibility in connection with issuing securities and accessing the capital markets on a streamlined basis. These provisions include those related to:

- Status as a Well-Known Seasoned Issuer ("WKSI") under Rule 405 of Regulation C;
- Eligibility to rely on offering exemptions available under Regulations A, D, and E;
- Use of the "forward-looking statements" safe harbor under the Private Securities Litigation Reform Act; and
- Receipt of cash solicitation payments from investment advisers under Rule 206(4)-3 of the Advisers Act.

The automatic disqualifications can be triggered by entry of court-ordered injunctions, administrative actions (including negotiated resolutions), and criminal indictments and convictions involving a number of different securities laws violations, including violations of the anti-fraud provisions of the securities laws.

Parties who are facing automatic disqualification may seek a waiver from the Commission, which has issued guidance with respect to the various factors that it considers in determining whether to grant a waiver. These factors include the duration of the conduct that precipitated the triggering event, whether the disqualified party had responsibility for the conduct, remedial steps taken in reaction to the conduct, and the impact that disqualification will have on the applying party.[1] Under the current process, a party seeking a waiver may discuss its request with the SEC Staff prior to its submission to the Commission, and the Staff will typically advise applying parties whether it intends to recommend that the Commission grant the waiver request. Upon entry of the order that triggers disqualification, the Commission will

[1] *See, e.g.*, Division of Corporation Finance, "Revised Statement on Well-Known Seasoned Issuer Waivers," April 24, 2014.

consider and vote on the waiver request, which may be granted by a majority vote of the Commissioners, in closed session.

The Bad Actor Disqualification Act of 2019

The Draft Bill seeks to make changes to some of the key aspects of the disqualification waiver process. Among other things, the Draft Bill would:

- Introduce the use of temporary waivers, which permit the Commission to vote to provide a disqualified entity with a single 180-day temporary waiver if it has demonstrated that "immediate irreparable injury" would occur as a result of disqualification;
- Require the Commission to grant a waiver request only if it finds that such waiver is "in the public interest," "necessary for the promotion of investors," and "promotes market integrity" without regard to the direct costs associated with disqualification;
- Require a notice and comment period and public hearing before the Commission's final waiver determination;
- Prohibit the Commission or its Staff from advising a disqualified entity of the likelihood that its waiver request will be granted; and
- Require the Commission to maintain a database of all entities who have applied for and been denied a waiver.

If enacted, the Draft Bill would strip much of the Commission's discretion in considering whether to grant waiver requests. Indeed, the legislation appears to seek to address concerns that waivers are too readily granted to financial institutions, noting that automatic disqualifications are "inappropriately underutilized" and that "waivers of the automatic disqualification provisions are disproportionately granted to the largest financial institutions on Wall Street, many of which are recidivists. Between July, 2003, and December, 2014, large financial firms received the vast majority of waivers of sanctions, about 82 percent of 201 total waivers."[2]

Though the largest financial institutions receive the majority of waivers granted, that may well be the result of the operation of the automatic disqualification provisions rather than any favoritism toward those institutions on the part of the Commission. The scope and breadth of these provisions, when combined with the broad footprint of the largest financial institutions, frequently result in disqualification for conduct that is unrelated to the forfeited benefits. First, many of the automatic disqualification provisions are triggered by a disqualifying event involving either the parent issuer or its affiliates or subsidiaries. As a result, a parent financial institution with WKSI status is frequently disqualified because of conduct at a subsidiary that is unrelated to its role as an issuer or related disclosures. Second, the automatic disqualification provisions are so broad that their application can sometimes lead to unanticipated (and illogical) results. For instance, the so-called "bad boy" disqualifications from participation in private offerings under Rule 506 of Regulation D are triggered when a broker-dealer is convicted of scienter-based fraud.[3] However, they are also triggered by an administrative cease-and-desist order pursuant to Section 15(b) of the Securities Exchange Act (the "Exchange Act") that is accompanied by an undertaking.[4] As a result, absent a waiver, a financial institution would lose its ability to participate in all

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

[3] 17 C.F.R. § 230.506(d)(1)(v)(A).

[4] 17 C.F.R. § 230.506(d)(1)(iv)(B).

private offerings pursuant to Rule 506 of Regulation D if its broker-dealer agreed to settle a relatively minor internal controls violation, such as failure to maintain the written policies and procedures required by Section 15(g) of the Exchange Act.

Accordingly, while the Draft Bill seeks to ensure that financial institutions are not favored by the Commission, it could result in a process that is unduly punitive because it eliminates the discretion that the Commission currently enjoys to grant waivers and avoid unnecessarily draconian (and likely unintended) sanctions as a result of the scope and breadth of the disqualification provisions.

The New Bill Could Make It Significantly More Difficult for the SEC to Exercise Its Enforcement Authority

As a practical matter, financial institutions considering a negotiated resolution frequently do so because they are seeking the certainty of settlement, even when they might prevail in litigation. It is imperative, however, that settling parties understand all the terms and consequences of settlement before entering a resolution, including the potential for a disqualification that can have far-reaching impact on their market participation and businesses. Today, while the Commission makes the ultimate decision whether to waive disqualification – usually on the same day that the triggering order is entered in connection with a negotiated resolution – settling parties typically understand what the Staff's recommendation to the Commission will be with regard to whether a waiver should be granted. While imperfect, this information is critical because it allows a settling party to assess all of the consequences of entering a settlement. In the absence of any certainty as to whether a settlement is likely to result in disqualification, we may see an increase in contested enforcement actions.

Further – and, paradoxically, given the stated objectives of the Draft Bill – adoption of the Draft Bill could result in fewer enforcement actions by the SEC because of the resources needed to resolve matters through litigation as opposed to a negotiated settlement. If financial institutions are wary of resolving enforcement actions through negotiated settlement for fear of disqualification, it is unlikely that the SEC will have the resources to litigate every potential securities violation identified in its investigations through to resolution. Indeed, Co-Director of Enforcement Steve Peikin has recognized that the SEC's enforcement "resources are limited and need to be thoughtfully deployed," and that they must "think hard about the messages we want to send and the types of cases we want to bring" and focus those resources accordingly.[5] If the Draft Bill is adopted, the Enforcement Staff may have to be even more discerning with respect to which actions it will pursue so that it appropriately utilizes its limited resources to meet its mission of protecting investors, potentially resulting in no action on violations that it may have previously been able to settle in an administrative action.

[5] *See* Steven Peikin, "Keynote Address to the UJA Federation" (May 15, 2018), available at **https://www.sec.gov/news/speech/speech-peikin-051518#_ftnref2**.

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