ALERT MEMORANDUM

Proposed Bad Actor Disqualification Act of 2019 Would Severely Limit the Availability of Waivers for Institutions Entering into Settlements with the SEC and DOJ

July 9, 2019

Last month, Representative Maxine Waters, Chair of the House Financial Services Committee, introduced a discussion draft of the "Bad Actor Disqualification Act of 2019" (the "Proposed Act"). Similar to proposed legislation Rep. Waters introduced in 2015 and 2017, the effect of the Proposed Act, if passed, would be to dramatically increase the burdens on institutions seeking waivers from disqualifications under the federal securities laws, including those for Well-Known Seasoned Issuers ("WKSI"), certain exemptions from registering securities offerings, and protection from fraud claims predicated on forward-looking statements. Indeed—given that the Proposed Act would require that all waiver applications be open to public comment and hearing and vote by the Securities and Exchange Commission ("Commission" or "SEC"), and that the Commission be barred from considering the "direct costs" of a denial to the applicant, but rather only the interests of the public, investors, and market integrity—the effect may be to essentially eliminate waiver applications and grants in all but the most severe cases. The Proposed Act targets "the largest financial institutions on Wall Street," which, unsurprisingly given their business models, request and receive a disproportionate share of waivers. However, by its terms the Proposed Act applies more broadly to all issuers and is not limited to financial institutions.

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1. Background

The federal securities laws contain a number of provisions allowing qualifying entities certain accommodations designed to ease the burdens, including costs, time, and litigation risk, associated with issuing securities. These include:

- WKSI status, allowing companies to offer securities without prior review from SEC staff and the ability to use a less burdensome written communication to sell securities—a so-called "free writing prospectus."[1]

- Offering exemptions provided by Regulations A, D, and E under the Securities Act of 1933 ("Securities Act"), allowing, respectively, exemptions from registration for certain smaller offerings, for limited offers without regard to dollar amount of offering, and for business development companies and small business investment companies.[2]

- PSLRA safe harbor that protects companies from private securities fraud liability related to their forward-looking statements, such as projections about revenue and income.[3]

- Receipt of cash payment from an investment adviser for solicitation activities under the Investment Advisers Act of 1940.[4]

Broadly speaking, however, these accommodations are not available to entities that are found to have engaged in wrongdoing—including pursuant to an SEC enforcement proceeding, settled or litigated, and criminal convictions—absent a waiver from the Commission.[5] Under current practice, waiver applicants typically submit draft waiver requests to SEC staff in the relevant division. Such requests are not initially made public, and the applicant can withdraw the request if the staff indicates that their division, acting by delegated authority, or the full Commission, is unlikely to grant it.[6] Under current law, the Commission and staff have significant discretion in determining whether to grant waivers. For example, the SEC grants WKSI and Regulations A, D, and E waivers upon a showing of "good cause," under which, pursuant to published guidance, it considers a number of factors, including who was responsible for the misconduct, the duration of the misconduct, what remedial steps were taken, and the effects of a denial on the waiver applicant itself, among other factors.[7]

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[1] *See* 17 C.F.R. § 230.163, § 230.405.

[2] *See* 17 C.F.R. § 230.251, § 230.500, § 230.506, § 230.602.

[3] *See* 15 U.S.C. § 77z-2(c), § 78u-5(c).

[4] *See* 17 C.F.R. § 275.206(4)-3.

[5] *See* 15 U.S.C. § 77z-2(b)(1)(A), § 78u-5(b)(1)(A); 17 C.F.R. § 230.262(a), § 230.405, § 230.506(d)(1), § 230.602(b)-(d).

[6] The Division of Corporation Finance has delegated authority to grant relief from WKSI, Regulation A, and Regulation D disqualifications. *See* 17 C.F.R. § 200.30-1(a)(10), § 200.30-1(b)(1), § 200.30-1(c). However, the Commission has not delegated authority to grant relief from the safe harbor and Regulation E disqualifications. *See* JPMorgan Chase & Co., Exchange Act Release No. 75009, (May 20, 2015) (order); Thomas Weisel Partners LLC, Securities Act Release No. 8494, (Sept. 24, 2004) (order).

[7] *See* SEC, Division of Corporation Finance, *Revised Statement on Well-Known Seasoned Issuer Waivers* (Apr. 24, 2014), available at http://www.sec.gov/divisions/corpfin/guidance/wksi-waivers-interp-031214.htm; SEC, Division of Corporation Finance, *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.; 17 C.F.R. § 230.602(e). The safe harbor disqualification may be waived "to the extent otherwise specifically provided by rule, regulation, or order of the Commission." 15 U.S.C. § 77z-2(b), § 78u-5(b). For a cash solicitation payment disqualification, a waiver in the form of a no-action letter may be provided under certain conditions, such as if a company acting as a solicitor makes disclosures about its disqualifying conduct to those solicited, when the disqualifying event is an administrative proceeding. *See* Dougherty & Company, LLC, SEC No-Action Letter, (S.E.C. Div. of Inv. Mgmt. July 3, 2003). When the disqualifying event is not an administrative proceeding, a no-action letter is granted on a case-by-case basis. *See id.*

2. Proposed Changes to the Disqualification Waiver Process

The Proposed Act would change the disqualification waiver regime for these accommodations in several significant ways, each likely making it more difficult for an entity to obtain a waiver.

- Use of temporary waivers as a first step. A disqualified applicant seeking a waiver would need to petition the Commission for a single 180-day temporary waiver upon a showing of "immediate irreparable injury," a high standard commonly associated with preliminary injunctive relief in the federal courts.[8] Immediately following a Commission vote on a temporary waiver petition, both the petition and the Commission's order containing an explanation of its decision would be published.[9]

- Heightened standard in order for the Commission to grant a waiver request. After the 180-day temporary waiver expires, the Commission would not be able to waive permanently a disqualification unless it determines that such waiver: "(i) is in the public interest; (ii) is necessary for the protection of investors; and (3) promotes market integrity."[10] The Commission would not be able to consider "direct costs"—a term left undefined in the Proposed Act—to an applicant of denial.[11]

- Notice and comment period and public hearing. Before a determination is made by the Commission, the public would need to be given adequate notice of the pending waiver decision and a chance to present their views, including at a public hearing.[12]

- Elimination of advance notice. The Commission staff would no longer have the discretion to informally inform an entity of its recommendation or the likelihood of a waiver being granted or denied.[13]

- Recordkeeping requirement for the Commission. The Commission would have to keep a public record of withdrawn waiver petitions, and would be required to maintain a database of all applicants whose waiver petitions were denied.[14]

- Unaffected waivers. Another waiver often sought is from Section 9(a) of the Investment Company Act of 1940's disqualification of certain entities—such as those with certain convictions within the past 10 years—from serving as an investment adviser, depositor, or principal underwriter for registered investment companies.[15] Under current law, the Commission "shall" grant that waiver on a showing that the disqualification would be "unduly or disproportionately severe or that the conduct of [the disqualified] has been such as not to make it against the public interest or protection of investors to grant such [waiver]."[16] The Proposed Act does not change the waiver process for Section 9(a)'s disqualification, which may be because the standard for granting that waiver is already similar to the new standard that the Proposed Act seeks to implement. However, the Proposed Act would require the Comptroller General to study the Commission's waiver process for Section 9(a) disqualification, including comparing the standard for that kind of waiver with the new standard imposed by the Proposed Act, and to issue a report to Congress within 180 days of the enactment of the Proposed Act.[17]

[8] Bad Actor Disqualification Act of 2019, 116th Cong. (June 2019), § 3(d)(1)(A), available at https://financialservices.house.gov/uploadedfiles/bills-116pih-badactor.pdf.
[9] *Id.*
[10] *Id.* at § 3(d)(1)(B).
[11] *Id.*
[12] *Id.* at § 3(d)(1)(C).
[13] *Id.* at § 3(d)(1)(D).
[14] *Id.* at § 3(d)(1)(E), § 3(d)(2).
[15] *See* 15 U.S.C. § 80a-9(a).
[16] 15 U.S.C. § 80a-9(c).
[17] Bad Actor Disqualification Act of 2019, 116th Cong. (June 2019), § 4, available at

3. Potential Implications

Given current political realities, the likelihood of the Proposed Act becoming law in the near future seems slim. Nonetheless, if passed in anything like its current form, the Proposed Act would work a significant change from the current waiver regime by making the waiver process far more costly and less certain for those seeking relief. In addition to making it harder to seek and obtain waivers, the Proposed Act may complicate the Commission's enforcement program in a number of other ways.

- Additional uncertainty regarding waivers may decrease incentives to settle. As mentioned above, settlements—including the SEC's typical no-admit-no-deny settlement—can and often do trigger automatic disqualifications under the federal securities laws. As such, it is important for companies to be able to assess the likelihood of receiving a disqualification waiver when considering whether and on what terms to resolve a case. The elimination of advance notice and the introduction of public deliberation into the disqualification waiver process contemplated by the Proposed Act would make that assessment far more difficult. Moreover, companies may wish to avoid the public scrutiny inherent in any such hearing. Thus, depending on the importance of waivers to an applicant's business (costs that the Commission would no longer be allowed to consider), companies may determine it is in their interest to litigate rather than settle certain kinds of cases. Companies that do settle may determine it is not worth seeking a waiver, given the public scrutiny, thereby increasing the costs of accessing the securities markets.

- Large financial institutions and other large companies may experience difficulty obtaining a temporary waiver. Under the "immediate irreparable injury" standard for granting temporary waivers, large financial institutions and other large companies may be treated differently from other entities on the basis of their size and diversity of their business—which may be viewed by the Commission as large and diverse enough to weather any injury to a specific area of their business. This is particularly so given the fact that many large institutions have lost certain exemptions in the past—and survived—thereby making an argument that another disqualification would cause irreparable injury more difficult to sustain.

- Permanent waivers would likewise be harder to obtain. The Proposed Act introduces a number of factors increasing the burden on waiver requests—including replacing the "good cause" standard with a three-prong test, prohibiting the Commission from considering costs to the applicant of a denial, eliminating delegation of waivers to Commission staff, and mandating an opportunity for public comment and hearing. Given that applications would now play out in public and that the Commission itself—and not its staff—would have to expressly consider each such application, the pressure to deny applications, particularly for the initial temporary application period that does not require public comment, may be increased both from the standpoint of public perception and due to resource constraints at the Commission.

- The public process may function to impose additional enforcement sanctions. Indeed, it would surely be the case that the conduct that gave rise to the settlement would be scrutinized anew during the notice and comment period and public hearing. The Commission could be vulnerable to pressures to impose additional sanctions on a company through a waiver denial, thereby subjecting the company to additional punishment beyond that imposed by the underlying enforcement action—presumably after careful deliberation

https://financialservices.house.gov/uploadedfiles/bills-116pih-badactor.pdf. The proposal also omits offerings under Regulation Crowdfunding and Section 4(a)(7) of the Securities Act, both of which have disqualification provisions. *See* 17 C.F.R. § 227.100, § 227.503; 15 U.S.C. § 77d.

and consideration of all the factors (including the wrongful conduct at issue).[18]

- There may be a decline in SEC enforcement actions. The SEC has limited resources and aims to expend those resources judiciously, covering the enforcement matters it considers priorities, the vast majority of which are settled without litigation.[19] Should more companies choose to litigate because waivers are unavailable, the Enforcement Division may have fewer resources to investigate new matters. Or, the SEC's Enforcement Division could simply turn its sights to other pockets of the securities markets where waiver issues would be less likely to arise, thereby ironically taking attention and focus away from policing Wall Street's largest financial institutions.

4. Conclusions

The Proposed Act seeks to make waivers from disqualifications under the federal securities laws more difficult to obtain, and may be intended to provide for greater accountability for wrongdoers. However, if the Proposed Act becomes law, the actual result may be fewer resolutions and enforcement actions, and where enforcement action is taken, the imperfect imposition of additional and uncertain collateral punishment piled on top of the carefully considered sanctions contemplated by the enforcement action itself. The Proposed Act may have a particularly problematic impact on global companies with multiple lines of businesses, where the disqualifying conduct of far-flung affiliates could potentially impair capital-raising activities for the entire corporate group. Although the Proposed Act aims to target large financial institutions for receiving a disproportionate share of waivers, it may not fully take into account that in many or most circumstances, the conduct leading to the disqualification is unrelated to the businesses most affected by the disqualification.[20]

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[18] A July 3 pronouncement by SEC Chairman Jay Clayton illustrates this point. *See* Jay Clayton, *Statement Regarding Offers of Settlement* (July 3, 2019), available at https://www.sec.gov/news/public-statement/clayton-statement-regarding-offers-settlement. While the Commission has traditionally taken the view that disqualification is not an additional enforcement sanction, Chairman Clayton's statement recognizes that disqualification can be a significant factor in an entity's determination whether to settle an action. Chairman Clayton noted that the Commission's practice in recent years of considering settlement offers and waiver requests on a segregated basis "can add complexity," and "often is inconsistent with appropriate consideration of the substance and interconnected nature of the matters at issue and undermines factors that drive appropriate settlements." Therefore, he announced that "a settling entity can request that the Commission consider an offer of settlement that simultaneously addresses both the underlying enforcement action and any related collateral disqualifications." Chairman Clayton's sentiment further shows why the changes contemplated by the Proposed Act may have a detrimental effect on settlements.

[19] *U.S. Securities and Exchange Commission Annual Report, Division of Enforcement* (2018), available at https://www.sec.gov/files/enforcement-annual-report-2018.pdf.

[20] This Alert Memorandum was prepared with the assistance of Avion Tai, David Wagner, and Tyler Good-Cohn.