Simpson Thacher

Regulatory and Enforcement Alert

A Legislative Proposal That Would Reshape the SEC Disqualification and Waiver Process

June 26, 2019

Earlier this month, Congresswoman and House Financial Services Committee Chair Maxine Waters introduced a bill that, if passed, would radically reshape the Securities and Exchange Commission's (the "SEC" or the "Commission") process for waiving disqualifications automatically triggered by the resolution of certain types of government enforcement actions. The proposed legislation, entitled the "Bad Actor Disqualification Act of 2019," revives discussion of what had become a polarizing issue for the Commission in the aftermath of the financial crisis: whether, and under what circumstances, the SEC should grant such waivers.

Putting aside questions about what appears to be the central premise of the draft bill—namely, that waivers have been too readily granted, particularly to large financial institutions—we fear that the changes contemplated by the proposal could: (1) inject politics into the waiver process; (2) introduce significant uncertainty for companies considering settlement of government proceedings; and (3) as a result, hamstring the ability of the Commission and other law enforcement authorities to settle cases they otherwise might have been able to resolve without the expenditure of resources required to litigate.

Background

Under the federal securities laws, certain types of government enforcement actions trigger automatic disqualifications,[1] preventing the subjects of those actions from engaging in certain activities: e.g., privately placing securities under Rule 506 Regulation D; issuing securities on Form S-3 or F-3, reserved for "Well Known Seasoned Issuers" (i.e., WKSIs); or advising or underwriting mutual funds. The purpose of these disqualifications is not (and has never been) to sanction the party subject to disqualification. The statutes

[1] Enforcement actions ranging from settlement of an administrative proceeding with the SEC to a criminal conviction in the United States or abroad can trigger automatic disqualifications.

and rules under which enforcement actions are brought include their own penalty and remedial provisions. Rather, by design, disqualification is a prophylactic tool to protect investors and capital markets from future misconduct. As former Commissioner Daniel Gallagher has explained: "Some apparently want disqualifications to operate as an additional sanction to impose on respondents who have offered to settle an enforcement matter with the SEC . . . The SEC's authority to impose sanctions for violations of the federal securities laws is both remedial and punitive in nature. . . . However, automatic disqualifications are not, and were never intended to be, either remedial or punitive in nature . . . [t]reating the waiver consideration process like the enforcement sanction process effectively, and inappropriately, conflates automatic disqualifications with remedial and punitive sanctions."[2]

The federal securities laws and rules that provide for disqualification also give the Commission substantial latitude to waive a disqualification based on a showing of "good cause." Historically, the SEC granted waivers where the disqualification would affect an activity or line of business having little nexus to the conduct that triggered the disqualification in the first place. As former SEC Chair Mary Jo White has said: "Very often, the misconduct at issue in the enforcement case involves a relatively limited number of a firm's employees or a specific business line, and is wholly unrelated to the activities that would be the subject of disqualification."[3] For example, a broker-dealer affiliate that settles with the SEC for violating its net capital rules could disqualify the entire firm from participating in private placement offerings under Rule 506 – activity divorced from the misconduct.

Since the financial crisis, there has been increased debate within the SEC about whether the Commission disproportionally grants waivers to large financial institutions. In 2014, former SEC Commissioner Kara Stein coined the term "too big to bar" in her dissent from a Commission waiver.[4] Former Chair White and former Commissioner Gallagher countered former Commissioner Stein's dissent in public speeches in which they both defended the current regulatory regime and the SEC's broad discretion to grant waivers.

The Proposed Legislation

Congresswoman Waters' draft bill decries the frequency of waivers and says that they are "disproportionately granted to the largest financial institutions on Wall Street." The premise is questionable. The SEC has in

---

[2] Former SEC Commissioner Daniel Gallagher in his remarks at the 37th Annual Conference on Securities Regulation and Business Law, Why is the SEC Wavering on Waivers?, (Feb. 13, 2015), https://www.sec.gov/news/speech/021315-spc-cdmg.html#_ftn5.

[3] Former Chair White explained the history of disqualifications and the waiver process. *See* Understanding Disqualifications, Exemptions and Waivers Under the Federal Securities Laws, Remarks at the Corporate Counsel Institute, Georgetown University (Mar. 12, 2015), https://www.sec.gov/news/speech/031215-spch-cmjw.html.

[4] *See* 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. 18, 2014), https://www.sec.gov/news/public-statement/2014-spch042814kms#_ftnref7.

fact denied waivers in many cases and conditioned them on compliance undertakings in others.[5] Moreover, that financial institutions have received the lion's share of waivers is unsurprising—as other types of companies would be less likely to need or seek waivers from, for example, the mutual fund disqualification or the disqualification from serving as a private placement agent.

Under the proposed legislation, the Commission could initially grant only a temporary waiver lasting 180 days upon a showing that the waiver application has demonstrated "immediate irreparable injury."[6] All petitions for a temporary waiver, along with the order containing the explanation for the Commission's determination, would be published. Following the temporary waiver, the Commission would be required to publish the waiver petition in the Federal Register and hold a public hearing on the merits of the petition. The Commission could proceed to a vote on the waiver only after the public was given a chance to comment and attend a hearing. Further, the proposed legislation would forbid the Commission staff from advising a waiver petitioner on the likelihood of success of its petition.

Observations

The proposed legislation could politicize the waiver process. Allowing for public comment and requiring a public hearing on every waiver runs the risk of politicizing (or further politicizing) the waiver process. There are good reasons that the Commission's (and other enforcement authorities') consideration of whether to bring or resolve an enforcement action takes place outside of public view. Those decisions should be made in as dispassionate and as objective a fashion as possible. A public waiver process may transform disqualifications from a prophylactic tool to a punitive measure.

The proposed legislation could create significant uncertainty for parties considering settlement. Defendants seek certainty and finality when negotiating settlements with enforcement authorities. By further bifurcating the settlement and waiver processes,[7] the legislation makes it considerably more difficult

---

[5] According to calculations presented by former Chair White, between January 2014 and March 12, 2015 (the date of Chair White's remarks), while seven WKSI waivers were granted, at least four were denied; and while 13 Rule 506 waivers were granted, at least 14 were denied. Chair White explained that these statistics do not account for instances where "inquiries are made to the staff seeking guidance and information and a company or individual that is subject to a disqualification is not identified. It also does not capture the situation where a disqualification has occurred and no waiver is ever sought." The SEC's waiver evaluation process is rigorous. The SEC reviews among other things "the nature of the violation, the duration of the wrongdoing, the specific employees involved and their level of seniority" and also considers "whether the conduct touched at all upon the activity at issue in the disqualification." *See supra* note 3.

[6] Such a standard is far afield from today's "good cause" standard – and represents another way in which the draft legislation departs from the use of waivers as a prophylactic tool.

[7] One of the *current* problems with the waiver process is that the Commission artificially separates its decisions authorizing an enforcement action and approving a settlement on the one hand, from its decision to waive (or not waive) any resulting disqualification on the other hand. But as a practical matter, in today's set-up, a settling party has a fairly good idea of whether a waiver will be granted when its offer of settlement is being considered by the Commission.

for a settling company to realize those goals. In short, under the waiver process contemplated by the draft bill, a company will not know what the terms of its bargain are.[8]

As a result, the proposed legislation may create impediments to settlement. As a result of the greater uncertainty (and the public hearing process) that the draft bill would inject into the settlement process, the proposal may push companies to fight rather than settle. Companies that do not know whether they will be disqualified from certain activities as a result of settlement, but do know they will face a public hearing on that question, will invariably think differently about the settlement calculus. In short, the legislation may disincentivize settlement and force the Commission and other enforcement authorities to expend significant resources and litigate cases they otherwise would have been able to resolve. It is hard to imagine the SEC's recent enforcement/self-reporting initiatives—such as the mutual fund share class initiative or the municipal disclosure initiative—working as seamlessly if self-reporting companies could not be certain about waivers.

Conclusion

The draft legislation would significantly alter the SEC's waiver process—at the risk of (further) politicizing that process, transforming disqualifications into penalties and introducing greater uncertainty into the settlement process. We hope those consequences, along with questions about the bill's underlying central premise, receive close attention in the event that the bill moves forward.

[8] Perhaps recognizing that such uncertainty is an inevitable byproduct of the proposed legislation's revised waiver process, the legislation leaves untouched the waiver process for mutual fund disqualifications in Section 9(a) of the Investment Company Act of 1940. The lingering possibility of a mutual fund shutdown while a waiver was under consideration for 180 days or more might have been more uncertainty than the bill's sponsor was willing to accept.

For further information about this Alert, please contact one of the following authors or your regular Simpson Thacher contact.

NEW YORK CITY

Brooke E. Cucinella
+1-212-455-3070
brooke.cucinella@stblaw.com

Stephen M. Cutler
+1-212-455-2773
stephen.cutler@stblaw.com

Nicholas S. Goldin
+1-212-455-3685
ngoldin@stblaw.com

Joshua A. Levine
+1-212-455-7694
jlevine@stblaw.com

Michael J. Osnato, Jr.
+1-212-455-3252
michael.osnato@stblaw.com

Rebecca A. Sussman
+1-212-455-3228
rebecca.sussman@stblaw.com

WASHINGTON, D.C.

Jeffrey H. Knox
+1-202-636-5532
jeffrey.knox@stblaw.com

Cheryl J. Scarboro
+1-202-636-5529
cscarboro@stblaw.com

Meaghan A. Kelly
+1-202-636-5542
mkelly@stblaw.com

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

Simpson Thacher

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower A
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000