Why is the SEC Wavering on Waivers? Remarks at the 37th Annual Conference on Securities Regulation and Business Law

Commissioner Daniel M. Gallagher

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Thank you, Doug [Clayton] for that kind introduction. I am honored to be here with you today at this important conference.

For me, this event marks the close of a hugely gratifying and enlightening three-day tour of the great State of Texas. I have met with the troops at Fort Hood to discuss investor protection issues—this time, the investors being the brave men and women in our armed forces. I made another stop on what I have been calling my small business "listening tour" with an engaging group of small business owners in Ft. Worth. And, I was able to conduct my second town hall style discussion with the excellent staff in the SEC's Ft. Worth Regional Office. I view it as part of my charge as an SEC Commissioner to travel outside of Washington, DC when my schedule permits, so I can directly hear about the issues that affect individuals, business owners, and other participants in the capital markets who don't have a voice inside the Beltway, and of course it is always a rewarding experience to meet with our staff in the SEC's regional offices.

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Today I am going to talk about an important topic that lies squarely at the intersection of the SEC's policy divisions and its enforcement program: waivers from disqualifications under the federal securities laws.

As many of you know, individuals and entities that are found – or deemed, by virtue of a settlement – to have committed certain bad acts are potentially subject to a variety of disqualifications prohibiting them from engaging in business activities or from relying on exemptions that otherwise would be available to them. Depending on the facts and circumstances, the Commission may choose to waive such a disqualification. Factors considered by the Commission in deciding whether to waive a disqualification include, among others, the types of individuals and entities involved in the misconduct, whether the misconduct was "willful", whether the misconduct resulted in a violation of the anti-fraud provisions of the securities laws, the duration of the conduct, and any remedial steps taken.

Some of these disqualifications are triggered automatically, for example upon the entry of a court-ordered injunction or an order in an administrative proceeding, whether through a settlement or following trial. Others are discretionary, requiring affirmative Commission action to impose the disqualification.

These provisions have been part of the federal securities laws almost as long as the federal government has been involved in the securities markets. Indeed, the first was adopted in 1936 just two years after the SEC was created as part of the offering exemptions contained in Regulation A.[1] Over the decades, a number of other disqualifications have been adopted, generally alongside exemptions from registration under the Securities Act of 1933 or related to activities governed by the Investment Advisers and Investment Company Acts of 1940.

Recently, there has been a significant amount of debate, both inside and outside the agency, about how the Commission ought to be approaching these disqualifications. As you may have noticed, I am not one to shy away from heated debates. And if we are going to have a proper debate on this topic, it must be an informed one. To that end, we first need to answer a few threshold questions – why did Congress and earlier Commissions choose to include these disqualifications in the federal securities law? What purpose do they serve? Were they intended to be backward looking sanctions for misconduct? Or, were they meant to be forward-looking and prophylactic?

For many disqualification provisions, the legislative and regulatory history is silent. Take, for example, Regulation A. Reg A was promulgated to bridge the gap between private financing transactions and initial public offerings under the 1933 Act.[2] The Commission built in an automatic disqualification provision for issuers who were subject to any court-ordered injunction, but the agency record is devoid of any guidance about the intended purpose of the provision. Alas, the agency could get away with rules like that back then. Today we'd need at least 1,000 pages!

The rulemaking record for Regulation D,[3] adopted in 1982, is similarly silent on the rationale for including an automatic disqualification. The Commission simply incorporated the disqualification found in Reg A without spilling a drop of ink addressing the purpose of the disqualification or the Commission's objectives in including it.

Where Congress and the Commission have clarified the objectives of disqualification provisions, however, there is a common theme of keeping so-called "bad actors" out of the industry and thereby preventing fraud.

Take, for example, Section 9(a) of the Investment Company Act of 1940, one of the earliest disqualification provisions to appear in federal securities law.[4] Section 9(a) establishes an automatic disqualification from acting as an adviser to a registered investment company that is triggered upon the entry of a court-ordered injunction. Commenting on an early version of the bill in the Senate hearings leading up to the Act's adoption, Judge Robert Healy, one of the original five Commissioners appointed to the SEC, explained the intent of the drafters of Section 9(a) as follows: "What we were trying to accomplish . . . was to get rid of persons with criminal records, persons who were under injunctions . . . for improper practices in connection with securities. . . . Our purpose was simply to try to get that type of person out of this business where such persons ought to be out of it."[5]

A similar articulation can be found in connection with the promulgation of SEC Rule 405, which was adopted in 2005, which prohibits issuers that have violated the anti-fraud provisions of the federal securities laws from qualifying as "well-known seasoned issuers" or "WKSIs."[6] In the proposing release for Rule 405, the Commission stated:

> "The categories of ineligible issuers include issuers that are not compliant with their Exchange Act reporting obligations, issuers that may raise greater potential for abuse, and issuers that have violated the federal securities laws previously. Certain of these issuers have been viewed historically as unsuited for short-form registration or ineligible for disclosure-related relief."[7]

And, in perhaps the clearest expression of the legislative intent behind a disqualification provision, Senator Dodd explained that Section 926 of the Dodd-Frank Act, which mandated that the SEC promulgate Rule 506(d) of Regulation D[8] – the "Bad Actor Rule" – was intended to "disqualify felons and other 'bad actors' who have violated Federal and State securities laws from *continuing* to take advantage of the rule 506 private placement process. This will reduce the danger of fraud in private placements."[9]

A common thread runs through the legislative and SEC records underlying each of these disqualification provisions: Congress and the SEC may be willing to allow for exemptions from otherwise applicable restrictions or burdens, but only to those persons who are unlikely to abuse that relief through fraudulent or other improper conduct. They recognized that the disqualifications were intentionally over-broad and thus necessitated an exemptive process to be employed when the facts

and circumstances warranted a less heavy-handed approach. For example, in his Senate testimony on Section 9(a), Judge Healy acknowledged that there might be situations where an otherwise disqualified registrant might at some point be rehabilitated, and therefore there ought to be a process for waiving the disqualification upon a showing of good cause.[10]

This history should inform and guide the current debate about the proper role of waivers. In a new, insightful article that will be very important for this debate, Emory Law Professor Urska Velikonja asserts that there are two competing justifications underlying the use of automatic disqualifications: (i) reducing recidivism, and (ii) using the disqualifications as "sanction enhancement."[11] The former is a forward-looking measure aimed at reducing the likelihood of future fraud; the latter is a backward-looking measure aimed at enhancing the Commission's ability to punish serious misconduct beyond the statutory and judicial limits otherwise imposed on the Commission's enforcement remedies.

Historically, the Commission and the staff have approached the disqualification and waiver process against the backdrop of the first policy goal of reducing recidivism. Waiver requests were dispassionately considered by the relevant policy division staff, on the merits and not in conjunction with the underlying enforcement case giving rise to the disqualification. Most of these waiver requests were handled and decided through the use of authority delegated by the Commission to the staff.[12]

This approach allowed the agency, after a careful consideration of the relevant facts and circumstances, to determine whether a waiver applicant presented a risk of future harm to the markets or other market participants. And, this process was far from a "rubber stamp." In 2010, for example, the SEC's Division of Corporation Finance, acting by delegated authority, rejected WKSI-waiver applications from the likes of Citigroup and Dell following their high profile settlements with the Commission.[13]

Recently, however, there has been a movement to treat disqualifications as, to use Professor Velikonja's term, "sanction enhancements." 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 or who are otherwise subject to a disqualifying civil injunction or criminal conviction.

The SEC's authority to impose sanctions for violations of the federal securities laws is both remedial and punitive in nature. Its remedial tools include equitable powers such as issuing injunctions, prohibiting individuals from serving as officers and directors of public companies, barring individuals from acting in certain capacities in the markets, requiring the retention of independent consultants, mandating governance and business reforms, and, of course, ordering disgorgement of ill-gotten gains. The SEC also has authority to impose financial penalties designed to punish violations of the federal securities laws.

However, automatic disqualifications are not, and were never intended to be, either remedial or punitive in nature, and therefore historically have been handled outside of the sanctioning process. Treating the waiver consideration process like the enforcement sanctioning process effectively, and inappropriately, conflates automatic disqualifications with remedial and punitive sanctions.

Clear evidence that automatic disqualifications are not appropriate as enforcement sanctions can be found in the fact that Congress chose not to incorporate them into the Securities Law Enforcement Remedies Act of 1990,[14] the statute most relevant to the Commission's sanctioning authority. Prior to 1990, except for limited penalty authority in insider trading actions,[15] the SEC was limited to imposing remedial relief in the form of injunctions and other equitable remedies, such as stop orders and disgorgement.[16] The Remedies Act, which implemented many of the recommendations of the highly respected Treadway Commission,[17] greatly expanded the SEC's sanctioning authority. The Act provided the SEC broad penalty authority and added a number of additional remedial enforcement tools, including the authority to impose administrative cease-and-desist orders and officer and director bars.

Noticeably absent from the Remedies Act, however, were any amendments to the then-existing disqualification provisions. If Congress believed that these provisions should be part of the Commission's sanctioning authority, it stands to reason that they would have included these disqualification provisions in the new, stand-alone, sanctioning provisions of the securities laws. Yet the words "disqualification" and "waiver" do not appear in the Remedies Act, and there is nothing in the agency or legislative record suggesting that automatic securities law disqualifications should be used as enforcement sanctions.

This is because automatic disqualifications are, in fact, blunt tools that were intended to serve a purpose distinct from enforcement sanctions. Testifying before Congress about the Remedies Act in 1989, former SEC Chairman David Ruder rightfully emphasized the importance of fashioning relief that was proportionate to the alleged misconduct, explaining that the Remedies Act would "give the courts and the Commission greater flexibility to tailor a remedy to the gravity of the violation. Thus, for example, the Commission could sanction broker-dealer misconduct requiring a punishment greater than censure but not warranting the drastic remedy of revocation or suspension of registration."[18]

On their face, automatic disqualifications are the antithesis of "flexible" sanctions that can be "tailored" to the "gravity of the violation." Instead, they are screening mechanisms that are triggered without any Commission or policy division staff consideration of the facts and circumstances.

Notably, in proposing the legislation that became the Remedies Act, the SEC expressly considered, but chose not to include, another tool recommended by the Treadway Commission – lawyer and CPA bars under Rule 102(e) of the Commission's Rules of Practice.[19] In a memorandum to Congress in support of the legislation, the Commission explained that its intent in adopting what was then Rule 2(e) was "not to utilize the rule as an additional weapon in its enforcement arsenal, but rather to determine whether a person's professional qualifications … are such that he is fit to appear and practice before the Commission. In short, Rule 2(e) proceedings are designed not to punish a person, but to protect the integrity of Commission proceedings."[20]

Like Rule 2(e) proceedings, automatic disqualification provisions were never meant to be an additional weapon in the Commission's enforcement arsenal.[21] Over the years, Congress and the Commission have had a number of opportunities to recast automatic disqualifications as sanctions – to convert them from fish to fowl – but have declined to do so.[22]

The Commission should continue to resist the temptation to conflate disqualifications and enforcement sanctions. Recent efforts to treat disqualifications as additional sanctions are inconsistent with the intended purpose of these provisions. And, this divergence from historical practice has unfairly left individuals and entities potentially subject to disqualifications unable to make rational decisions regarding defense strategy and settlement.

This is exacerbated by the informal, non-Commission-approved, practice recently followed by the Enforcement Division of not allowing respondents to condition settlements on the granting of waivers. This makes no sense to me. If a disqualification is now a sanction, then the waivers must be part of the settlement negotiations. This is especially true for financial services firms, which can effectively be sentenced to a corporate death penalty if certain waivers – Section 9 and Reg D in particular – are not granted.[23] If the Commission wants to put firms out of business, something that always should be on the table in extreme enforcement cases, we should be doing so with our authority over the registration provisions of the securities laws, <u>not</u> through automatic disqualifications.

This is why I have publicly stated, and I will repeat again now, that until such time as the Commission officially decides whether disqualifications will continue to be treated as sanctions or whether we will revert to the historical practice of treating them apart from the enforcement process, I will condition my vote on enforcement recommendations matters on an understanding of the planned disposition of requested waivers. A settlement should involve a meeting of the minds on all aspects of the resolution. A settlement should bring finality, and I cannot fulfill my duty as a Commissioner to cast a vote in favor of a recommendation without the ability to accurately assess what punishments will be

meted out to a respondent as a consequence of my action, and whether those punishments are just given the nature of the violation.

The Commission, as part of the federal government, cannot and should not administer any program, or partake in any activity, that creates uncertainty for market participants in an effort to provide maximum optionality for the agency. Notions of fairness and due process demand much more from us. And, it is not hard to see that the path we are on now will ultimately – if it has not already – work to the detriment of the agency and its critically important enforcement program.

Ideally, we would return to the historical practice of having the expert policy division staff dispassionately consider requests for waivers.[24] These dedicated staff members are best suited to assess each waiver request individually, on its merits, considering the facts and the circumstances of each case without background noise from the enforcement case inappropriately influencing that decision.

For those waiver requests that require a Commission vote, we have unfortunately arrived at a point, as I just discussed, where it is no longer possible to separately consider the merits of the enforcement case without also taking into account the potential impact a disqualification would have on the settling party. We therefore need to amend our practice so waiver requests that come up for a Commission vote are considered together with the enforcement recommendation in a single package, effectively and unfortunately treating the disqualifications as sanctions in those cases.

If, as a Commission, we are unable to settle on a sensible and fair path forward, it could become necessary for Congress to step in and provide needed clarification. While I would hope that we could find a way to restore order to this process at the agency level, I fear we may soon reach a point where legislative intervention is needed. If it comes to that, Congress should clearly draw the lines between disqualifications and enforcement sanctions under the federal securities laws. And if that is not possible, then they should remove the automatic triggers from disqualification provisions and leave implementation of such disqualifications to the discretion of the Commission as part of our sanctioning authority.

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Thank you for your time today and for allowing me to discuss this important topic. I hope you enjoy the rest of your conference.

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[1] Regulation A, SEC Release No. 33-632 (Jan. 21, 1936).

[2] *Id.* Prior to codification, Regulation A was a collection of individual rules issued by the Federal Trade Commission and the Commission during the period of 1933-1936. Each such rule exempted particular classes of securities from registration under the Securities Act. Regulation A's initial annual offering limit was raised from $100,000 to $300,000 in 1945, $500,000 in 1970, $1.5 million in 1978, and to its current level of $5 million in 1992.

[3] Regulation D, SEC Release No. 33–6389 (Mar. 8, 1982).

[4] Investment Company Act of 1940 §9(a), 15 U.S. Code § 80a–9(a). It is important to keep in mind that this provision was originally adopted in 1940 for an industry that looked nothing like what it has become today. In 1940, there were fewer than 500 registered investment companies with total assets of approximately $2.5 billion. Today, that number has ballooned to approximately 4,100 registered investment companies with $18.2 trillion under management. At the time Section 9 was adopted, investment companies typically were managed by relatively small partnerships, and it could not have

been foreseen that investment advisers and other service providers to investment companies would in the future be part of large financial service organizations.

[5] Statement of Judge Robert Healy, S. 3580 at 874-75, 76th Cong. 3d Sess. (1940). The early version of the bill would have required officers and directors of investment companies to register with the Commission. Accordingly, Section 9(a) originally was drafted to give the SEC authority to reject applicants subject to criminal convictions, injunctions, or other disqualifications.

[6] Securities Act *Rule 405*, *17 C.F.R.* **§** *230.405* (2005).

[7] Securities Offering Reform, Proposed Rule, Release No. 33-8501 (Nov. 3, 2004).

[8] Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, SEC Release No. 33-9414 (July 10, 2013) (emphasis added).

[9] Statement of Senator Dodd, CR S. 3813 (May 17, 2010).

[10]Statement of Judge Robert Healy, S. 3580 at 874-75, 76th Cong. 3d Sess. (1940) ("At the same time we were trying to make provision for the case of a man who within 10 years might have been guilty of a crime, who nevertheless had made a come-back and regained the respect of his fellowmen, and who should not in fairness be subject to the prohibition. . . . I suggest that you append to it another section providing that with respect to any person who finds himself in that unfortunate position, if he can establish before the Commission . . . that nevertheless it is not against the public interest for him to occupy that position, the Commission may then permit it.").

[11] Professor Urska Velikonja, Emory University School of Law, *Waiving Disqualification: When Do Securities Law Violators Receive a Reprieve?*, Working Paper at 119, available at http://papers.ssrn.com/abstract=2563726.

[12] Commission staff, through delegated authority, considers all requests for waivers from automatic disqualifications except for those under Section 9(a) of the Investment Company Act of 1940, Regulation E, and the safe harbor for forward looking statements under the PSLRA. Accordingly, most waiver requests are handled by staff in the relevant policy Division. Pursuant to Commission rules, however, any Commissioner can call for a Commission vote matters that have been otherwise delegated to the staff, and any affected party may petition for Commission review of an action taken by delegated authority. 17 CFR 201.431.

[13] *See supra* n. 11 at 131 ("[A]necdotal evidence suggests that at least some waiver requests are denied. For example, when Dell settled an enforcement action for accounting fraud in October 2010, it was a WKSI. The settlement triggered old bad actor and ineligible issuer disqualifications. Dell received a waiver from the old bad actor disqualification provision, and remained eligible to raise capital under Regulation A and Rule 505 of Regulation D, but did not receive a waiver from the ineligible issuer disqualification under Rule 405."); *see also* August 18, 2014 Letter from Cleary Gottlieb Steen & Hamilton LLP to SEC Division of Corporation Finance ("In 2010, Citigroup was deemed an ineligible issuer, and thus lost its WKSI status, because of its settlement with the Commission in connection with alleged material misstatements about exposure to sub-prime mortgages."), available at http://www.sec.gov/divisions/corpfin/cf-noaction/2014/citigroup-081814-405.pdf.

[14] Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931.

[15] *See* Insider Trading Sanctions Act of 1984 Pub. L. 98-376, 98 Stat. 1264 (granting SEC limited penalty authority in insider trading cases); Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. 100-704, 102 Stat. 4677 (enhancing penalty authority to include "controlling persons"

and requiring broker-dealers and investment advisers to maintain policies and procedures designed to prevent the misuse of material non-public information).

[16] Paul S. Atkins and Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, 13 FORDHAM J. CORP. & FIN. L. 367, 383 (2008) ("Prior to 1990, the SEC's statutory purpose for enforcing the securities laws was to provide remedial relief for aggrieved investors and to deter future violations. The enforcement program began by serving primarily a remedial purpose, through the Commission's injunctive powers and the disgorgement remedies that the Commission fashioned. In the decades following the Wells Committee, the Commission's enforcement actions began to shift from remedial to punitive in nature. This shift of emphasis arose from the new powers that Congress gave the SEC, such as the authority to impose officer and director bars, penalties against individuals and registered entities, and censures in administrative actions.").

[17] The National Commission on Fraudulent Financial Reporting – known as the "Treadway Commission" in honor of its Chairman, former SEC Commissioner James Treadway, Jr. – was a privately sponsored and funded organization formed in 1985 with a mission "to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence." *See generally* Joseph A. Grundfest, *The Treadway Commissioner Report: Two Years Later* (January 26, 1989) available at http://www.sec.gov/news/speech/1989/012689grundfest.pdf.

[18] Financial Reporting Practices (Part 2): Hearing Before the Subcomm. on Oversight and Investigations of the Comm. on Energy and Commerce, 100th Cong., 2d Sess., at 25 (May 2, 1988) (statement of SEC Chairman David S. Ruder).

[19] 17 C.F.R. § 201.102(e).

[20] Memorandum of the Securities and Exchange Commission in Support of the Securities Law Enforcement Remedies Act of 1989, at 4 (Apr. 1, 1988).

[21] My colleague, SEC Chair Mary Jo White, got to the heart of the matter in a recent letter to Senator Sherrod Brown when she explained that "[w]aivers should not be granted to either 'soften' the impact of an enforcement action nor should they be used to add additional penalties to an enforcement action when disqualification is not warranted or necessary." Letter from Mary Jo White, Chair of the Securities and Exchange Commission, to The Honorable Sherrod Brown (Sept. 8, 2014), available at: http://www.mofo.com/~/media/Files/Articles/140908BrownSEC PolicyReWaivers.pdf.

[22] Congress most recently passed up the opportunity to act in Dodd-Frank, and instead further muddied the waters by expressly including collateral bars – in which the agency directly sanctions an individual under one provision of federal securities law, but then collaterally bars that person from association with professionals governed by other provisions – as a remedial sanction. While collateral bars and automatic disqualifications are similar tools that are both meant to keep bad actors from engaging in certain conduct, in Dodd-Frank Congress made a conscious choice to add only collateral bars to the enforcement remedies available to the Commission. Of course, Dodd-Frank is just the latest chapter in the tortured history of the SEC's treatment of collateral bars. For much of the agency's history, the Commission regularly imposed collateral bars despite a lack of clear Congressional guidance as to its authority to do so. Following a 1999 decision by the D.C. Circuit holding that collateral bars were invalid, *Teicher v. SEC,* 177 F.3d 1016, the SEC refrained from imposing them for over twenty years until, suddenly, it was given explicit statutory authority to impose such bars by the runaway freight train of Dodd-Frank, Dodd Frank § 925. For decades, the SEC's authority with respect to collateral bars has been a moving target, leaving respondents uncertain about the potential consequences of their conduct. We are seeing the same scenario unfolding with the agency's approach to automatic disqualifications.

[23] Of course a Rule 506 bar could equally be a death sentence for a private company that relies on the exemption to raise needed capital, but thus far Rule 506 has generally had a greater impact on

financial services firms than individual issuers, given the wide scope of activities conducted by financial services firms other than private placement services.

[24] I should make it clear that, despite my desire to have the waiver process revert to the staff, I fully respect any Commissioner's reasonable request to review matters delegated to the staff. *See* §4A(b) of the Securities Exchange Act of 1934: "The vote of one member of the Commission shall be sufficient to bring any such [delegated] action before the Commission for review." 15 U.S.C. §78d-1(b).

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