

Statement on Rule 194, Applications By Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or Be Involved in Effecting Security-Based Swaps



Commissioner Kara M. Stein

Dec. 19, 2018

I want to join the Chairman in thanking the staff for the hard work that went into this release and all of the other security-based swap rules.

Today, the staff is recommending that the Commission adopt rules regarding whether security-based swap^[1] dealers and major participants can employ people, or associate with companies, that have engaged in securities fraud, felonies, and other wrongdoing.^[i] In the industry, the prohibition against associating with such persons or entities is known as a “bad actor bar.”^[2]

Specifically, bad actors are people and entities who have been found to have violated our laws, have been barred or suspended from handling other people’s money, or have been convicted of a felony or certain other misdemeanors within the last 10 years.

Since the 1940s, the bad actor bar has been a tool that has been successfully used to reduce the risk of future harm to investors and our markets.^[3]

This tool is often triggered automatically by civil or criminal enforcement action. It is also intended to be forward-looking. Indeed, the triggering misconduct may be unrelated to the conduct ultimately barred. For example, a firm criminally convicted of manipulating foreign exchange rates automatically loses privileges related to the offer and sale of securities. That was intended by design. Automatic disqualifications are a protective safeguard and a mechanism to reduce potential risks to our markets. If firms or individuals have a demonstrable record of violating our laws, shouldn’t we examine whether they pose a future threat to either investors or our markets?

And, since the 1940s, the Commission has been empowered to waive these automatic disqualifications, but only if there is “good cause” to do so. When I arrived at the Commission, however, I was surprised to learn that many of these good cause waivers appeared to be automatically triggered themselves. Time and again, the Commission

appeared to find “good cause” in almost every conceivable circumstance. This led to firms and companies increasingly relying on the Commission’s routine issuance of waivers, which not only eliminated some of the consequences of misconduct—consequences that could positively contribute to a firm’s compliance and conduct going forward—but, in effect, abrogated the underlying statute or rule that required automatic disqualification in the first instance.

During my tenure, I have advocated for a facts and circumstances review of each application for a waiver. I’ve also questioned the use of blanket waivers, when limited and conditional waivers appear to be more appropriate.^[4] Unfortunately, I am sad to say that today’s rule moves in the opposite direction.

I have two main concerns with today’s rule.

First, today’s rule will give preferential treatment to companies that have committed fraud or were convicted of crimes. It would allow them to participate in buying, selling, trading, or effectuating security-based swap transactions—no questions asked. The rule will provide an automatic exception for a company that committed fraud, or engaged in the wholesale theft of assets and allow it to continue to participate in the securities swap market. There will be no application for a waiver, no hearing, no weighing of the factors, and no affirmative decision by the Commission. Companies will be automatically cleansed and be considered good actors in one procedure-less swoop.

My second concern is that the rule grants the power to waive bad actor bars concerning individuals to a host of regulators and non-regulators-- the Commodity Futures Trading Commission (“CFTC”), the National Futures Association (“NFA”), the Financial Industry Regulatory Authority (“FINRA”), and any national securities exchange.

Indeed, I am reminded of the colossal regulatory failures during the financial crisis, when regulators pointed to one another each disclaiming responsibility. By making everyone responsible, then no one is responsible.

My concerns are not theoretical. As the release acknowledges, fraudsters, felons, and other wrongdoers to whom a bad actor bar would apply pose a real risk to both counterparties and the market. Employees with prior misconduct are five times as likely to engage in new misconduct. In addition, approximately a third of employees with misconduct in their past engage in repeated misconduct.^[5] Further, the release also notes that weaknesses in a firm’s compliance culture can contribute to future misconduct: an employee is 37 percent more likely to engage in misconduct if they have co-workers with a history of misconduct.^[6]

There has been a vigorous debate about the collateral consequences for both companies and individuals incurred as a result of misconduct. Should companies lose privileges as a result of associating with others who have demonstrated misconduct? Or are certain firms too important to lose privileges? Are they too-big-to-bar?

I would have supported a rule that permitted a person or entity subject to a statutory disqualification to apply to the Commission for a waiver.^[7] There are occasions when it makes sense to waive such bad actor provisions. And since I have been at the Commission, I have been advocating for the establishment of fair and transparent processes for those seeking such waivers. Fair and transparent processes provide clarity to market participants, level the playing field between businesses big and small, and focus the Commission on its investor protection duties. As I said previously, the Commission abrogating its authority, for little reason other than to carve out wrongdoers from having to obtain waivers from the Commission is a loophole that I cannot sign onto.

Simply put, it’s our mission to use all the regulatory tools in our toolbox to ensure market integrity and to protect investors. This means that we must ensure that wrongdoers —whether they are companies or individuals—do not pose a threat to the system or our investors. In my view, this rule does not adequately protect against such a threat. It is for this reason that I cannot support today’s rule.

Thank you.

[1] Swaps, also called over-the-counter derivatives, are contracts in which two parties agree to exchange money based upon the occurrence of some other event, such as a change in interest rates or the default of a bond. As bilateral contracts, swaps link together the firms that trade them into a web or daisy chain that allows risk to travel quickly between firms. For example, if one bank trading swaps fails, the defaults on its swaps contracts could result

in a chain of margin calls and defaults across all of its counterparties. These defaults could, in turn, set off another chain of defaults at those firms' counterparties. Security-based swaps include, for example, credit default swaps (CDS) and equity swaps.

[2] The statutory disqualification (or bad actor bar) to which Rule 194 applies were created by Congress as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Act"). One of the principle purposes of the Act was to limit collateral damage to innocent bystanders when security-based swap entities fail. In particular, the bad actor bars were designed to protect investors and the securities-based swap market from people who have engaged in wrongdoing. They are a prophylactic measure designed to protect against future harm by known wrongdoers. They are quite simply good public policy.

[3] Investment Company Act of 1940 §9(a), 15 U.S. Code § 80a-9(a).Section 9(a) provided the Commission with authority to reject applicants subject to criminal convictions, injunctions, or other misconduct.

[4] *See* Remarks Before the Consumer Federation of America's 27th Annual Financial Services Conference, Commissioner Kara M. Stein, *available at* <http://www.sec.gov/news/speech/spch120414kms>. *See also* Statement of Judge Robert Healy, S. 3580 at 874-75, 76th Cong. 3d Sess. (1940); One of the first SEC Commissioners (Commissioner Robert Healy) observed decades ago, "[W]e 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."

[5] Release at 94-95.

[6] *Id.* at 95.

[7] *See* Statement on Final Rules for Security-Based Swap Dealer and Major Swap Participant Registration and on Proposed Rules for Applications to Waive Title VII Statutory Disqualifications, Commissioner Kara M. Stein, Aug. 5, 2015, *available at* <https://www.sec.gov/news/statement/sbs-dealer-registration-final-rules-and-194-proposed-rules.html>

[i] A statutorily disqualified person is a person who:

(A) has been and is expelled or suspended from membership or participation in, or barred or suspended from being associated with a member of, any self-regulatory organization, foreign equivalent of a self-regulatory organization, foreign or international securities exchange, contract market designated pursuant to section 5 of the Commodity Exchange Act (7 U.S.C. 7), or any substantially equivalent foreign statute or regulation, or futures association registered under section 17 of such Act (7 U.S.C. 21), or any substantially equivalent foreign statute or regulation, or has been and is denied trading privileges on any such contract market or foreign equivalent;

(B) is subject to—

(i) an order of the Commission, other appropriate regulatory agency, or foreign financial regulatory authority—

(I) denying, suspending for a period not exceeding 12 months, or revoking his registration as

a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, security-based swap dealer, or major security-based swap participant or limiting his activities as a foreign person performing a function substantially equivalent to any of the above; or

(II) barring or suspending for a period not exceeding 12 months his being associated with a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, security-based swap dealer, major security-based swap participant, or foreign person performing a function substantially equivalent to any of the above;

(ii) an order of the Commodity Futures Trading Commission denying, suspending, or revoking his registration under the Commodity Exchange Act (7 U.S.C. 1 et seq.); or

(iii) an order by a foreign financial regulatory authority denying, suspending, or revoking the person's authority to engage in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof;

(C) by his conduct while associated with a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, security-based swap dealer, or major security-based swap participant, or while associated with an entity or person required to be registered under the Commodity Exchange Act, has been found to be a cause of any effective suspension, expulsion, or order of the character described in subparagraph (A) or (B) of this paragraph, and in entering such a suspension, expulsion, or order, the Commission, an appropriate regulatory agency, or any such self-regulatory organization shall have jurisdiction to find whether or not any person was a cause thereof;

(D) by his conduct while associated with any broker, dealer, municipal securities dealer, government securities broker, government securities dealer, security-based swap dealer, major security-based swap participant, or any other entity engaged in transactions in securities, or while associated with an entity engaged in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof, has been found to be a cause of any effective suspension, expulsion, or order by a foreign or international securities exchange or foreign financial regulatory authority empowered by a foreign government to administer or enforce its laws relating to financial transactions as described in subparagraph (A) or (B) of this paragraph;

(E) has associated with him any person who is known, or in the exercise of reasonable care should be known, to him to be a person described by subparagraph (A), (B), (C), or (D) of this paragraph; or

(F) has committed or omitted any act, or is subject to an order or finding, enumerated in subparagraph (D), (E), (H), or (G) of paragraph (4) of section 78o(b) of this title, has been convicted of any offense specified in subparagraph (B) of such paragraph (4) or any other felony within ten years of the date of the filing of an application for membership or participation in, or to become associated with a member of, such self-regulatory organization, is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4), has willfully made or caused to be made in any application for membership or participation in, or to become associated with a member of, a self-regulatory organization, report required to be filed with a self-regulatory organization, or proceeding before a self-regulatory organization, any statement which was at the time, and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application, report, or proceeding any material fact which is required to be stated therein.

15 U.S.C. §78c(39).

Section 78o(b) referenced in the definition of statutory disqualification definition provides:

(B) has been convicted within ten years preceding the filing of any application for registration or at any time thereafter of any felony or misdemeanor or of a substantially equivalent crime by a foreign court of competent jurisdiction which the Commission finds—

(i) involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, any substantially equivalent activity however denominated by the laws of the relevant foreign government, or conspiracy to commit any such offense;

(ii) arises out of the conduct of the business of a broker, dealer, municipal securities dealer, municipal advisor, government securities broker, government securities dealer, investment adviser, bank, insurance company, fiduciary, transfer agent, nationally recognized statistical rating organization, foreign person performing a function substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act (7 U.S.C. 1 et seq.) or any substantially equivalent foreign statute or regulation;

(iii) involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds, or securities, or substantially equivalent activity however denominated by the laws of the relevant foreign government; or

(iv) involves the violation of section 152, 1341, 1342, or 1343 or chapter 25 or 47 of title 18 or a violation of a substantially equivalent foreign statute.

(C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, municipal securities dealer, municipal advisor, government securities dealer, security-based swap dealer, major security-based swap participant, transfer agent, nationally recognized statistical rating organization, foreign person performing a function substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent foreign statute or regulation, or as an affiliated person or employee of any investment company, bank, insurance company, foreign entity substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent foreign statute or regulation, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

(D) has willfully violated any provision of the Securities Act of 1933 [15 U.S.C. 77a et seq.], the Investment Advisers Act of 1940 [15 U.S.C. 80b-1 et seq.], the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.], the Commodity Exchange Act, this chapter, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.

(E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, this chapter, the rules or regulations under any of such statutes, or the rules of

the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if—

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

....

(G) has been found by a foreign financial regulatory authority to have—

(i) made or caused to be made in any application for registration or report required to be filed with a foreign financial regulatory authority, or in any proceeding before a foreign financial regulatory authority with respect to registration, any statement that was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any application or report to the foreign financial regulatory authority any material fact that is required to be stated therein;

(ii) violated any foreign statute or regulation regarding transactions in securities, or contracts of sale of a commodity for future delivery, traded on or subject to the rules of a contract market or any board of trade;

(iii) aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of any statutory provisions enacted by a foreign government, or rules or regulations thereunder, empowering a foreign financial regulatory authority regarding transactions in securities, or contracts of sale of a commodity for future delivery, traded on or subject to the rules of a contract market or any board of trade, or has been found, by a foreign financial regulatory authority, to have failed reasonably to supervise, with a view to preventing violations of such statutory provisions, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision; or

(H) is subject to any final order of a State securities commission (or any agency or officer performing like functions), State authority that supervises or examines banks, savings associations, or credit unions, State insurance commission (or any agency or office performing like functions), an appropriate Federal banking agency (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813(q))), or the National Credit Union Administration, that—

(i) bars such person from association with an entity regulated by such commission, authority, agency, or officer, or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or

(ii) constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct.