SPEECHES & TESTIMONY

Dissenting Statement of Commissioner Dan M. Berkovitz

In re Tower Research Capital LLC: Waiver of SEC "Bad Actor" Disqualifications

November 7, 2019

I dissent from the Commission's approval of the administrative settlement with Tower Research Capital LLC ("Tower"). While I agree with the substantial remedial sanctions the CFTC is imposing on Tower, I do not support the Commission's decision to grant Tower a waiver from the "bad actor" disqualification in Securities and Exchange Commission ("SEC") Rule 506.[1] The CFTC has neither the legal authority nor the expertise to determine the appropriate procedures and qualifications for public and private securities offerings and how best to protect investors from fraud in the securities markets. These matters are the core responsibility of the SEC, not the CFTC.

As a legal matter, the CFTC does not have the authority to make determinations—such as by providing binding "advice" under SEC Rule 506—as to the appropriate procedures or qualifications for the offering of securities under the Securities Act of 1933 ("Securities Act"). There is nothing in the Commodity Exchange Act ("CEA"), the securities laws, or any other law that authorizes the CFTC to make these securities law determinations. "[A]n agency literally has no power to act . . . unless and until Congress confers power upon it."[2] Because there has been no delegation by Congress to the CFTC to administer the registration of securities, including determining which firms should be exempt from registration requirements, the CFTC's determination that Tower should not be disqualified from certain registration requirements under the Securities Act is *ultra vires*—it has no legal effect.

As a matter of policy, it is inappropriate for the CFTC—the federal derivatives regulator—to opine on, or determine, whether securities offerings should be exempt from registration under the securities laws. The CFTC does not possess the expertise to determine the appropriate procedures for securities offerings, or how to best protect investors from fraud in securities offerings. Administering the securities laws is the responsibility of the SEC.

The SEC's process for waiving automatic disqualifications does not serve the interests of the CFTC, the SEC, or the public. The rule complicates the CFTC's ability to prosecute violations of the CEA because firms that are subject to disqualification will not resolve their actions unless the CFTC agrees to waive the disqualification. And the rule does not advance the SEC's interests in protecting investors because decisions regarding waivers are being made by a derivatives regulator for a hodgepodge of reasons, not by the securities regulator according to the criteria it has established for those decisions.

I look forward to working with my colleagues, and our counterparts at the SEC, to find a solution that extracts the CFTC from the SEC's waiver process and allows the CFTC to resolve its enforcement actions without delay.

Background on "Bad Actor" Disqualifications

SEC Rule 506 is one of three rules under the SEC's Regulation D that exempts certain securities offerings, particularly to accredited investors, from the registration requirements of the Securities Act.[3] Because registered public offerings entail significant SEC disclosure requirements, an exempt private offering under Rule 506 enables companies to obtain funding faster, at less cost, and with much less disclosure than with a public offering.[4] In addition, securities offered in compliance with Rule 506 are considered "covered securities" and are largely exempt from state regulation.[5] Rule 506 is by far the most widely used Regulation D exemption, accounting for 95% of all Regulation D offerings and trillions of dollars in capital raised.[6] Regulation A is an analogous exemption from SEC registration requirements for certain public offerings.[7]

Just as these registration exemptions have been around for decades, so have disqualification provisions than automatically ban corporations from using them when they run afoul of the securities laws. "'Bad actor' disqualification requirements . . . disqualify securities offerings from reliance on exemptions if the issuer or other relevant persons . . . have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws."[8] In the absence of a waiver, a company subject to one of these automatic disqualification provisions is not prohibited from participating in the capital markets, but it may not rely on the safe harbor exemptions, which substantially reduce their disclosure obligations and the cost and time of registration. Companies may also face reputational harm as a result of the ban.

Disqualifications and Waivers Under Section 926 of the Dodd-Frank Act

In July 2010, Congress enacted Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act[9] with the goal of enhancing oversight of the capital markets and reducing fraud in private offerings.[10] This provision required the SEC to adopt rules that disqualify certain securities offerings involving "bad actors" from relying on the safe harbor protections of Rule 506, which did not previously contain a disqualification provision.

Section 926 directed that the SEC adopt by rule bad actor disqualification provisions with respect to offerings of securities under Rule 506 that: (1) were "substantially similar" to SEC Rule 262, the disqualification provision then in existence under Regulation A; and (2) "disqualify any offering or sale of securities by a person that—(A) is subject to a final order of a State securities commission . . . , a State authority that supervises or examines banks, savings associations, or credit unions, a State insurance commission . . . , an appropriate Federal banking agency, or the National Credit Union Administration . . . ."[11] Congress did not identify the CFTC as an agency whose orders would give rise to automatic disqualification under SEC Rule 506, nor was the CFTC identified in Rule 262 at the time the Dodd-Frank Act was adopted.[12]

In response to this mandate, in 2011, the SEC proposed amendments to Rule 506. Although the CFTC was not identified in the statute, the SEC solicited public comment on whether CFTC orders should also trigger disqualification from the Rule 506 safe harbor from registration.[13] Two years later, the SEC adopted the new rule, adding the CFTC as an agency whose orders would automatically give rise to disqualification.[14] The SEC reasoned that "the conduct that would typically give rise to CFTC sanctions is similar to the type of conduct that would result in disqualification if it were the subject of sanctions by another financial services industry regulator," and that CFTC actions trigger consequences under other SEC rules.[15]

The new Rule 506 also provided that automatic disqualification "*shall not apply* . . . [i]f, before the relevant sale, the court *or regulatory authority that entered the relevant order*, judgment or decree *advises* in writing . . . that disqualification . . . should not arise as a consequence of such order, judgment or decree . . . ."[16] In 2015, the SEC conformed the bad actor provisions in Rule 262 to be substantially similar to those in Rule 506.[17]

SEC Rule 506 provides that the SEC may waive the disqualification "[u]pon a showing of good cause" and "if the Commission determines that it is not necessary under the circumstances that an exemption be denied."[18] The Commission (SEC) has delegated authority to grant waivers to the Director of its Division of Corporation Finance, but has retained authority to make any particular determination, "including granting [waivers] in connection with settling [an SEC] enforcement action."[19] The SEC's Division of Corporation Finance has issued guidance regarding the facts and circumstances it will consider when determining whether to issue a waiver from disqualification, including who was responsible for the misconduct; the duration of the misconduct; the remedial steps that have been taken to address the misconduct; and the impact if the waiver is denied.[20] Former SEC Chair Mary Jo White described the SEC's waiver determinations as "a thorough, rigorous, and principled application of the law to the particular facts of each case and a process that we continue to scrutinize and enhance. It is not at all a routine or kneejerk exercise."[21]

CFTC's Involvement in the Waiver Process

Given the consequence of Regulation D offerings to market participants, CFTC staff is regularly faced during settlement negotiations with requests to waive the SEC "bad actor" disqualification that would otherwise result from a CFTC enforcement action. In fact, firms inform the CFTC that they will not resolve its enforcement actions absent a waiver. This puts our agency in the untenable position of either issuing a waiver it is both unauthorized and unqualified to provide, or indefinitely delaying our enforcement actions until the SEC can render an opinion, which hinders the CFTC from performing one of its core missions—enforcing the CEA and Commission regulations. Facing this dilemma, the CFTC has grappled with how to respond to these waiver requests.[22] The result has been an incoherent foray beyond our jurisdictional boundaries and expertise, driven by the desire to avoid delays in concluding enforcement cases that can result from involving another federal agency in the settlement process.

Initially, following the adoption of the SEC Rule 506 disqualification provision in 2013, the CFTC included language in settlement agreements providing the requested waivers.[23] However, in mid-2015, following SEC Commissioner Stein's criticism of the CFTC's for its decision to grant a waiver to Deutsche Bank AG in a case involving manipulation and false reporting of LIBOR,[24] the CFTC suspended the granting of such requests and instead began referring those requests to the SEC.[25] In 2018, the CFTC resumed granting waivers of disqualification under SEC Regulations A and D.[26] It appears that this reversal was due to considerations of expediency—to avoid the potential delay and complication that could result from involving another federal agency in the CFTC's settlement negotiations.

CFTC Cannot and Should Not Issue Waivers of Disqualification under the Securities Laws

Considerations of expediency, however, do not expand the CFTC's legal authority beyond its statutory limits. "Regardless of how serious the problem an administrative agency seeks to address, however, it may not exercise its authority 'in a manner that is inconsistent with the administrative structure that Congress enacted into law.'"[27] Neither the CEA, the Securities Act, the Securities and Exchange Act of 1934, the Dodd-Frank Act, nor any other federal statute provides the CFTC with authority to determine the procedures a firm must follow for the public or private offering of securities.

Similarly, there is no statutory authority for the SEC to issue a rule that provides the CFTC with the authority to opine on public offerings of securities. The SEC cannot confer upon the CFTC powers that Congress has not delegated. "[A]n agency's power is no greater than that delegated to it by Congress."[28] Section 926 of the Dodd-Frank Act did not provide for the SEC to delegate to the CFTC authority to determine whether firms that violate fraud or manipulation provisions of the CEA should be disqualified from certain securities offerings. As the U.S. Court of Appeals for the Seventh Circuit has stated, "the CFTC and SEC [cannot] reapportion their jurisdictions in the face of a clear, contrary statutory mandate."[29]

Rule 506 provides that the automatic disqualification triggered by a CFTC order "shall not apply" if the CFTC "advises" the SEC in writing that such disqualification should not arise as a consequence of its order. But when the CFTC makes such a finding in one of its orders, it does not operate as discretionary "advice"; it is a legally binding waiver of the SEC's disqualification provisions.[30] Our involvement eliminates the need for the company to seek a waiver from the SEC, taking the ultimate decision out of the hands of our sister agency. This transfer of responsibilities was not contemplated by Congress in the Dodd-Frank Act and is inconsistent with the statutory division of responsibilities between these two agencies.

It is also inappropriate, as a matter of policy, for the CFTC to issue these waivers. The CFTC does not regulate the securities markets, nor do its Commissioners and staff have the relevant experience or information needed to analyze whether a market participant should be disqualified from certain securities offerings, and how to best protect securities investors from fraud. CFTC waivers have the additional consequence of preempting state authorities from regulating certain conduct the firms may undertake in their states. The determination of whether to issue a waiver "can be complex," and "the robust analysis performed by the Divisions of Corporation Finance and Investment Management has proven critical to the [SEC's] consideration of these issues."[31] When the CFTC makes determinations regarding waivers to firms that are the subject of its enforcement actions, the CFTC does not have the benefit of any such "robust analysis" of the SEC's Divisions of Corporation Finance and Investment Management. We should leave this determination to the agencies tasked with regulating securities trading.

Former SEC Chair Mary Jo White has emphatically described the SEC's core responsibility for implementing the securities laws and its process for waiving automatic disqualifications:

> We are responsible for administering the federal securities laws with each part of our mission as our —investors and market participants rightfully demand that we do so. The laws that provid disqualification, but also provide an accompanying authority for exemptions or waivers, reflect the ba that is at the core of our multi-faceted mission to protect investors, maintain fair, orderly, and eff markets, and facilitate capital formation. That must always be our overarching guide in everything w [32]

I encourage my colleagues to work with the SEC to properly allocate responsibilities across our respective agencies without delaying the resolution of CFTC enforcement actions.

I thank the CFTC's Division of Enforcement for their diligent and successful prosecution of the underlying violations of the CEA.

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[1] *See In re Tower Research Capital LLC*, CFTC No. 20-06, at 11 (Nov. 6, 2019) ("Based on the nature of the violations; the findings made, and the sanctions, conditions, and undertakings imposed in this Order; and the facts and representations in the Request Letter, the Commission advises that, under the circumstances, disqualification under [Rule 506] should not arise as a consequence of this Order.").

[2] *Louisiana Pub. Serv. Comm'n v. FCC,* 476 U.S. 355, 374 (1986).

[3] *See* Final Rule, Disqualification of Felons and Other "Bad Actors" From Rule 506 Offerings, 78 FR 44730, 44731 (July 24, 2013) ("Reg. D Final Rule"); SEC, Fast Answers, Rule 506 of Regulation D, available at https://www.sec.gov/fast-answers/answers-rule506htm.html.

[4] Urska Velikonja, Waiving Disqualification: When Do Securities Violators Receive a Reprieve?, 103 Cal. L. R. 1081, 1096-97 (Oct. 2015); *see also* Investopedia.com, Regulation D, available at https://www.investopedia.com/terms/r/regulationd.asp; *cf.* Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 FR. 21806, 21885 (Apr. 20, 2015) ("Reg. A Final Rule") ("The disqualification provisions also impose costs on issuers and covered persons. Issuers that are disqualified from using amended Regulation A may experience an increased cost of capital or a reduced availability of capital . . . .").

[5] *See* Reg. D Final Rule, at 44731 n.22 (explaining that the National Securities Market Improvement Act of 1996 preempts state registration and review requirements for transactions involving "covered securities.").

[6] *Id*. at 44731 n.15; Velikonja, *supra* note 4, at 1084 n.11 (noting that the amount of capital raised under Rule 506 exceeds "by an order of magnitude" capital raised in all other private offerings).

[7] *See generally* SEC, Regulation A, available at https://www.sec.gov/smallbusiness/exemptofferings/rega; Reg. A Final Rule.

[8] Reg. D Final Rule, at 44731.

[9] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, section 926, Pub. L. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act")

[10] *See* Statement of Senator Dodd, 156 Cong. Rec. S3813 (May 17, 2010) ("New Section 926 would 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."); *see also* Rep. on the Activity of the Comm. on Fin. Serv. for the 111th Congress, H.R. Rep. No. 111-702, 2011 WL 13942, at 204-05 (Jan. 3, 2011) ("To police this segment of our capital markets more effectively, Section 926 of the Dodd-Frank Act makes the registration exemption under Rule 506 unavailable if the issuer or its principals have been the subject of civil, criminal or administrative disciplinary proceedings, including actions brought by State securities, banking, or insurance regulators. This provision enhances the oversight of Rule 506 offerings under both State and Federal law.").

[11] Dodd-Frank Act, section 926(1), (2).

[12] *See* 17 CFR 230.262 (Apr. 2010).

[13] *See* Proposed Rule, Disqualification of Felons and Other "Bad Actors" From Rule 506 Offerings, 76 FR 31518, 31526 (June 1, 2011).

[14] 17 C.F.R. 230.506(d)(1)(iii); *see also* Reg. D Final Rule, at 44740.

[15] Reg. D Final Rule, at 44740.

[16] 17 C.F.R. 230.506(d)(2)(iii) (emphasis added). At the time Section 926 of the Dodd-Frank Act was adopted, SEC Rule 262 did not contain any provisions triggering automatic disqualification on the basis of other state or federal regulatory authorities' orders, with the exception of the U.S. Postal Service. *See* 17 CFR 230.262 (Apr. 2010). At the time the SEC adopted the Rule 506 "bad actor" disqualification provisions in 2013, no SEC regulations contemplated that the CFTC, or other authorities, would "advise" on whether disqualification should apply as a consequence of their orders.

[17] *See* 17 CFR 230.262 (2016); *see generally* Reg. A Final Rule.

[18] 17 CFR 230.506(d)(2)(i) (2019).

[19] SEC, Process for Requesting Waivers of "Bad Actor" Disqualification Under Rule 262 of Regulation A and Rules 505 and 506 of Regulation D, available at https://www.sec.gov/divisions/corpfin/guidance/262-505-waiver.htm.

[20] SEC, Division of Corporation Finance: Waivers of Disqualification under Regulation A and Rules 505 and 506 of Regulation D, available at https://www.sec.gov/divisions/corpfin/guidance/disqualification-waivers.shtml.

[21] SEC Chair Mary Jo White, Understanding Disqualifications, Exemptions and Waivers Under the Federal Securities Laws, Remarks at the Corporate Counsel Institute, Georgetown University, Washington D.C. (Mar. 12, 2015) ("Understanding Disqualifications"), available at https://www.sec.gov/news/speech/031215-spch-cmjw.html.

[22] Initially, CFTC orders providing the requested waiver did not undertake any analysis of whether disqualification should arise, stating only that "[u]nder the specific facts and circumstances presented here, . . . disqualification under [Rule 506] should not arise as a consequence of this Order." *See, e.g.*, *In re JPMorgan Chase Bank, N.A.*, CFTC No. 14-01, 2013 WL 6057042, at *14 (Oct. 16, 2013). In 2018, the CFTC began to frame its waivers as "advice," mirroring the language of SEC Rules 262 and 506, and explained that it was considering factors "similar to those considered by the SEC when it issues waivers of disqualification under Regulation A and Regulation D." *See, e.g.*, *In re Deutsche Bank AG*, CFTC No. 18-06, 2018 WL 684634, at *12 n.5 (Jan. 29, 2018). Today, in the Tower Order, the CFTC introduces new factors—"the nature of the violations; the findings made, and the sanctions, conditions, and undertakings imposed in this Order; and the facts and representations in the Request"—that it considered in determining that disqualification should not arise as a consequence of its order. *See In re Tower*, CFTC No. 20-06, at 11.

[23] *See In re JPMorgan*, CFTC 14-01, 2013 WL 6057042, at *14; *In re Citibank, N.A.*, CFTC No. 15-03, 2014 WL 6068386, at *13 (Nov. 11, 2014); *In re JPMorgan Chase Bank, N.A.*, CFTC No. 15-04, 2014 WL 6068387, at *13 (Nov. 11, 2014); *In re Royal Bank of Scotland plc*, CFTC No. 15-05, 2014 WL 6068388, at *12 (Nov. 11, 2014); *In re UBS AG*, CFTC No. 15-06, 2014 WL 6068389, at *13 (Nov. 11, 2014); *In re HSBC Bank plc*, CFTC No. 15-07, 2014 WL 6068390, at *15 (Nov. 11, 2014); *In re Deutsche Bank AG*, CFTC No. 15-20, 2015 WL 1874880, at *27 (Apr. 23, 2015).

[24] Commissioner Stein stated:

[B]based on a loophole contained in Rule 506(d)(2)(iii), the CFTC has intervened and prevented the bad actor disqualification question from even coming before the [SEC]. The CFTC saw fit to opine on the SEC's Rule 506 jurisprudence about whether Deutsche Bank AG should receive a waiver from automatic disqualification under SEC rules. It is unclear to me what, if any, analysis went into this decision and what prompted the CFTC to insert language into its final order stating that a bad actor disqualification "should not arise as a consequence of this Order." The implications of the CFTC's actions here—and in other actions—are deeply troubling. The [SEC] should closely review this provision and how it is being used.

SEC Commissioner Kara M. Stein, Dissenting Statement in the Matter of Deutsche Bank AG, Regarding WKSI (May 4, 2015), available at https://www.sec.gov/news/statement/dissenting-statement-deutsche-bank-ag-wksi.html.

[25] *See In re JPMorgan Chase Bank, N.A.*, CFTC No. 16-05, 2015 WL 9268695 (Dec. 18, 2015); Division of Corporation Finance No-Action, Interpretive and Exemptive Letters, Securities Act of 1933, Regulation D – Rule 506(d) Waivers of Disqualification, The Goldman Sachs Group Inc., et al., available at https://www.sec.gov/corpfin/corpfin-no-action-letters#regd506d (providing link to SEC Order).

[26] *See, e.g.*, *In re Deutsche Bank AG*, CFTC No. 18-06, 2018 WL 684634, at *12 (Jan. 29, 2018); *In re UBS AG*, CFTC No. 18-07, 2018 WL 684636, at *12; *In re HSBC Secs. (USA) Inc.*, CFTC No. 18-08, 2018 WL 684635, at *6 (Jan. 29, 2018).

[27] *FDA v. Brown & Williamson Tobacco Corp.,* 529 U.S. 120, 125 (2000) (quoting *ETSI Pipeline Project v. Missouri,* 484 U.S. 495, 517 (1988)).

[28] *Lyng v. Payne*, 476 U.S. 926, 937 (1986).

[29] *Bd. of Trade of the City of Chicago v. SEC,* 677 F.2d 1137, 1142 n.8 (1982), *vacated as moot*, 459 U.S. 1026 (1982) ("The role of the agencies remains basically to execute legislative policy; they are no more authorized than are the courts to rewrite acts of Congress.") (citing *Talley v. Matthews*, 550 F.2d 911, 919 (4th Cir. 1977)) (alterations omitted).

[30] The Merriam-Webster dictionary defines "advise" as: "1a—to give (someone) a recommendation about what should be done . . . ; 1b—caution, warn . . . ; 1c—recommend . . . ; 2—to give information or notice to: inform." *See* https://www.merriam-webster.com/dictionary/advise. Because the CFTC's action of advising that the waiver should not apply legally operates to waive the disqualification without any opportunity for the SEC to determine otherwise, the word "advise" in this context has the meaning of "to give information or notice to: inform." It is not a mere recommendation; it informs the SEC of a legal, binding determination that the otherwise applicable disqualification shall not apply.

[31] SEC Chair Jay Clayton, Statement Regarding Offers of Settlement (July 3, 2019), available at https://www.sec.gov/news/public-statement/clayton-statement-regarding-offers-settlement.

[32] White, Understanding Disqualifications, *supra* note 21.