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Expert Analysis

SEC's Reboot on Waiver Requests In Enforcement Settlements


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Securities and Exchange Commission (SEC) Chairman Jay Clayton recently announced a change in how the SEC will consider requests for waivers of certain serious collateral consequences that would otherwise result from settlement of an SEC enforcement action. These collateral consequences, often referred to as "bad actor" or "bad boy" provisions, can vary greatly and may disqualify an entity from conducting certain business or utilizing certain means to offer securities. Historically, a company often would not know unequivocally whether the commission would agree to waive these disqualifications until after the announcement of the settlement—a situation that brought a significant degree of uncertainty to the impact of a settlement decision.

Under the agency's new approach, the Commission will make known whether waivers will issue at the same time it provides a decision on a proposed settlement agreement. The Commission's more rational approach—which seems somewhat at odds with the proposed Bad Actor Disqualification Act of 2019 that would make it much harder for a settling party to obtain waivers—will allow companies and their shareholders to have certainty regarding the consequences of the resolution of SEC enforcement proceedings.

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Collateral Consequences Of Settling

The settlement of an enforcement action can result in potentially devastating disqualifications under the securities laws even if the settlement explicitly disclaims an admission of liability and the alleged wrongdoing involved only a few employees or a specific subsidiary or business area. Unbeknownst even to many experienced securities litigators, terms of certain settlements—such as cease and desist orders, the retention of an independent compliance consultant, or an injunction against further violations—automatically can trigger a number of disqualifications. The consequences may include loss of status as a well-known seasoned issuer, disqualification from serving as an investment adviser or underwriter to certain registered investment companies, loss of safe harbor provisions, and loss of other issuer registration exemptions provided under the securities laws.

In theory, the collateral consequences imposed after resolution of an enforcement action safeguard investors from bad actors

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who engage in misconduct. Former Commission Chair Mary Jo White noted, however, that often times the misconduct at issue is "wholly unrelated to the activities that would be the subject of the disqualification." She offered as an example a case in which a company resolved violations involving a failure to supervise a registered representative resulting in disqualifications in a separate area of the firm for those who participate in raising capital under a private placement exemption. In recognition of the expansive sweep of these provisions, the Commission retains the authority to grant waivers or exemptions in order to "calibrate the otherwise overly broad effect of disqualifications that prohibit an entity or individual from engaging in particular activities."

Under longstanding SEC practice, the waiver process is distinct from negotiations to resolve an enforcement action, though efforts are typically made to coordinate the timing of both aspects of a settlement. The SEC's Division of Enforcement staff is responsible for conducting investigations into possible violations of the securities laws and pursuing enforcement actions and civil law suits on behalf of the Commission, while the review of waiver requests has been overseen by staff at one or both of the Divisions of Corporation Finance (the division responsible for the review of corporate filings and providing legal and accounting support to investors, companies, and the Commission) and the Division of Investment Management (the division primarily responsible for administering the securities laws pertaining to investment companies, i.e., mutual funds, business development companies, and exchange-traded funds, and investment advisers), each of which has delegated authority over aspects of the waiver process. Thus, although the enforcement division is responsible for the settlement negotiations, waiver recommendations, and at times final relief determinations, are made by staff members from the divisions of Corporation Finance or Investment Management who are not involved in the investigation of the alleged wrongdoing or the conversations held between a potential defendant and the SEC enforcement staff.

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Waivers are to be granted when the applying company or individual demonstrates "good cause," as determined based on a number of factors, including who was responsible for the misconduct, the duration of the misconduct, remedial measures taken by the company, and the impact on the company, its customers and investors if the waiver is denied. As Clayton recognized in his statement, "The analysis informing this recommendation or determination can be complex because, for example, the businesses and operations of the entity affected by the collateral disqualifications may or may not be related to the conduct at issue, and the collateral consequences can range from immaterial to extremely significant and may or may not have an impact on investor protection." For all these reasons, Clayton observed, the analysis performed by the divisions of Corporation Finance and Investment Management is critical.

In June 2019, Representative Maxine Waters, Chair of the House Financial Services Committee, introduced the Bad Actor Disqualification Act of 2019, which would make it more difficult for settling entities to obtain waivers from disqualifications under the federal securities laws. The law would require all waiver applications be open to public comment, a hearing, and a vote by the Commission. The Commission would not be able to waive permanently a disqualification unless it determined that the waiver was in the public interest, was necessary for the protection of investors, and promoted market integrity. In addition, the Commission would no longer be permitted to consider the direct costs of the disqualifications to the applicant.

Many commentators and industry insiders oppose the legislation, believing it would make the waiver process significantly more cumbersome and decrease the number of waivers granted. Rather than protect the public, some opined that the law would “result in *de facto* additional penalties on settling parties that are often wholly unrelated to the conduct underlying the enforcement action.” Others argue that the proposed law would have a chilling effect on the negotiation and settlement of enforcement actions and lead to increased securities litigation.

Many companies choose to settle an enforcement action even when they believe the government’s case lacks merit because they prefer the certainty that a settlement brings. The one—sometimes latent—uncertainty that remained for these companies, however, was whether and when they would be able to obtain waivers from the disqualifications resulting from settlement. Accordingly, the need to submit signed settlement papers to the SEC without knowing whether related waiver applications would be granted or even considered contemporaneously presented significant practical problems. Clayton observed that the Commission’s former approach often led to protracted and unnecessarily complicated negotiations because a settling entity’s ability or willingness to settle naturally was informed by and dependent on its ability to obtain waivers.

New Approach To Disqualification Waivers

The SEC now will allow a corporation to seek simultaneous approval of a settlement offer and the waiver of any associated collateral consequences. According to Clayton, an offer of settlement that includes a concurrent waiver request negotiated with all the relevant divisions of the agency will be presented to the Commission as a single recommendation from the staff.

“This approach will honor substance over form and enable the Commission to consider the proposed settlement and waiver request contemporaneously, along with the relevant facts and conduct, and the analysis and advice of the relevant Commission divisions to assess whether the proposed resolution of the matter in its entirety best serves investors and the Commission’s mission more generally.” According to Clayton, the process of simultaneous settlement offers is not new to the agency.

In effect, the new process revitalizes past practice where—assuming counsel was aware of the issue—settlement offers were made by companies contingent on the receipt of a specified waiver. Clayton noted this prior practice in a footnote to his statement in opining that the changes would be a benefit to both investors and the Commission’s mission. According to Paul Eckert, a partner at WilmerHale who regularly advises clients in this area, “The chairman’s statement … greatly reduces the risk that key business lines—and the clients they serve—will be disrupted without notice. The policy retains a staff-driven waiver process that draws on subject matter expertise while ensuring the Commission receives coordinated recommendations as to all aspects of a proposed settlement.”

The new procedure makes no changes to the factors to be considered in making a waiver determination, and Clayton reinforced the agency’s continued reliance on the analysis conducted by the divisions of Corporation Finance and Investment Management. Accordingly, other than the opportunity to have waiver applications and settlement papers considered contemporaneously, and a respondent’s explicit ability to withdraw a settlement offer if a waiver application is denied, the substantive process likely will remain the same.

Conclusion

The agency’s reform of its bifurcated process, enabling an entity to know whether it will be granted any relief from the collateral consequences of a settlement offer, will go a long way to resolve longstanding problems faced by companies facing potential resolutions of SEC enforcement actions.