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Waiving Disqualification: When Do Securities Violators Receive a Reprieve?

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In addition to considerable sanctions, criminal and civil securities enforcement actions trigger an array of collateral consequences. This Article studies automatic “bad-actor” and “ineligible-issuer” disqualifications, which bar disqualified firms from relying on relaxed disclosure and reporting requirements when raising external capital. First adopted in 1940, the disqualifications were primarily intended to reduce the risk of future violations related to the sale of securities.

The SEC has the authority to waive disqualifications on showing of good cause, in particular where the defendant poses low risk of fraud in a disqualified offering. This Article reviews the population of 201 bad-actor and ineligible-issuer waivers granted between July 2003 and December 2014, and identifies three significant trends in the SEC’s exercise of waiver authority. First, large financial firms received a large majority of waivers, 81.6 percent. Smaller financial firms and nonfinancial companies rarely received waivers. The relative share of waivers issued to large financial firms is not necessarily a reason for concern if such firms are less likely to commit securities fraud than smaller and nonfinancial firms. This

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could be due to alternative risk-reduction mechanisms such as external oversight or superior self-policing. Second, the study finds that the SEC has developed unwritten criteria for granting waiver requests but has lacked transparency. Most significantly, firms charged with accounting fraud rarely receive a waiver, regardless of their size. But large firms charged with fraud related to structured mortgage securities do tend to receive waivers, even though such misconduct signals fraud risk. Moreover, waivers are often granted to repeat violators whose track record suggests problems with legal compliance. And third, the study reveals a shift in waiver practices over time. The number of granted waivers has declined since 2010, as scrutiny of the SEC's waiver practices has increased. Also, the SEC recently shifted from granting waivers in full to limited and conditional waivers, a practice that is consistent with the purpose of disqualifications.

This Article proposes that automatic disqualifications can be useful tools if deployed consistently and transparently. The SEC should articulate clear and justifiable criteria for automatic disqualifications based on indicators of future fraud. It should make principled and transparent decisions on whether, when, and under what conditions to grant waivers. Disqualifications can be blunt instruments. Rather than waive disqualifications in full, the SEC should expand its practice of granting limited and conditional waivers where waiver denial would be excessive.

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INTRODUCTION

On August 20, 2014, after months of negotiations, Bank of America reached a settlement with the U.S. Department of Justice, the Federal Housing Administration, the Government National Mortgage Association (“Ginnie Mae”), the Federal Deposit Insurance Corporation, and several state Attorneys General in a financial fraud action.¹ The settlement arose out of the packaging, marketing, sale, underwriting, and issuance of residential mortgage-backed securities and collateralized-debt obligations. Bank of America agreed to pay a record-breaking amount in fines and other relief—\$16.65 billion.² On the same day, Bank of America also reached a provisional settlement with the Securities and Exchange Commission (“SEC” or “Commission”) related to the same misconduct. It admitted wrongdoing and agreed to pay around \$245 million in monetary penalties.³ But the settlement could not be finalized for months because of a disagreement regarding a seemingly minor point: waivers from automatic disqualification provisions.⁴

Automatic disqualifications are collateral consequences of securities enforcement. Similar to felon disenfranchisement, they are triggered by certain enforcement actions related to violations of banking, financial, and securities

1. See News Release, Office of Pub. Affairs, U.S. Dep’t of Justice, No. 14-884, Bank of America to Pay \$16.65 Billion in Historic Justice Department Settlement for Financial Fraud Leading up to and During the Financial Crisis (Aug. 21, 2014), <http://www.justice.gov/opa/pr/bank-america-pay-1665-billion-historic-justice-department-settlement-financial-fraud-leading>.

2. See *id.*

3. See Press Release, SEC, No. 2014-172, Bank of America Admits Disclosure Failures to Settle SEC Charges (Aug. 21, 2014), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542719632>.

4. See David Michaels & Robert Schmidt, *BofA Mortgage Settlement Stalls over SEC Political Fight*, BLOOMBERG (Oct. 27, 2014, 2:00 AM), <http://www.bloomberg.com/news/articles/2014-10-27/bofa-mortgage-settlement-stalls-over-sec-political-fight>.

laws.⁵ They bar defendant firms and individuals from serving as investment advisors, receiving marketing and referral fees from fund managers, relying on safe harbors from the mandatory securities registration requirement, and taking advantage of relaxed disclosure requirements for large public companies.⁶ The SEC has the authority to waive disqualifications for good cause.⁷ Unlike disqualifications in banking laws, which can ruin a bank,⁸ disqualifications in securities laws are at most an inconvenience—or at least they were until recently.

Several factors have combined to make disqualifications in securities laws consequential. The most important is Section 926 of the Dodd-Frank Act of 2010, which authorized the SEC to add an automatic disqualification provision to Rule 506 of Regulation D.⁹ Effective since September 2013,¹⁰ the disqualification bars affected firms and individuals from conducting private placements under Rule 506. The addition is significant because Rule 506 is by far the most popular provision for raising external capital without making a public offering.¹¹ Every year, companies raise almost \$1 trillion in Rule 506 offerings, almost as much as they do in all public offerings combined.¹² For many firms, Rule 506 is the only provision they use to sell securities to investors.

At about the same time, several SEC Commissioners have taken an interest in automatic disqualifications and waivers. Two Democratic Commissioners have expressed concern that the SEC grants too many waivers to large financial institutions.¹³ At the end of April 2014, Commissioner Kara Stein publicly dissented from the grant of waiver from the ineligible-issuer

5. *See infra* Part I.B.

6. *See id.*

7. *See* 17 C.F.R. § 200.30–1(a)(10), (b)(1), (c) (2015).

8. For example, a guilty plea can cost the bank its banking license. *See* 12 U.S.C. § 93(d)(1)(B) (2012).

9. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 926, 124 Stat. 1376, 1851 (2010) (codified as amended in 15 U.S.C. § 77d (2012)).

10. *See* Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings, 78 Fed. Reg. 44730 (July 24, 2013) (codified at 17 C.F.R. pts. 200, 230, 239 (2014)).

11. The amount of capital raised under Rule 506 exceeds by an order of magnitude capital raised in all other private placements. *See* VLADIMIR IVANOV & SCOTT BAUGUESS, SEC, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009–2012 (2013), <http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf>.

12. *See id.* at 8–9. Two other proposed disqualification provisions have been added to proposed and final rules on crowdfunding and the amendment to Regulation A. *See* Crowdfunding, 78 Fed. Reg. 66428, 66499 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249); Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. 21806 (Apr. 20, 2015) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 240, 249, 260).

13. Kara M. Stein, Comm’r, SEC, 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. 28, 2014), <http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370541670244>.

disqualification to the Royal Bank of Scotland, triggered by the bank's guilty plea related to manipulating the London Interbank Offered Rate ("LIBOR").¹⁴ Commissioner Stein contended that disqualifications should be used in cases of serious misconduct, and worried that waivers were unfairly granted even in the face of egregious failures in legal compliance.¹⁵ By contrast, Republican Commissioner Gallagher has argued that automatic disqualifications should be generally waived, except where the "issuer's financial reporting cannot be trusted," offering a narrow recidivism-based rationale for disqualifications.¹⁶

Automatic disqualifications in securities laws are important for practitioners, enforcement staff, and firms when they negotiate settlements of civil and criminal enforcement actions.¹⁷ But they have received little scholarly attention beyond an amorphous concern that collateral consequences amount to a "corporate death penalty"¹⁸—an analogy that is clearly exaggerated when applied to automatic disqualifications in securities laws.

This Article studies automatic bad-actor and ineligible-issuer disqualifications, which bar disqualified firms from relying on Regulation A,

14. *Id.*

15. Commissioner Stein also noted that RBS's criminal conduct was "egregious," "relentless and protracted," and had "far-reaching consequences," and that the consequences of denying the waiver would have been modest. *Id.* Commissioner Stein clarified her position in a subsequent speech and explained that disqualifications are a "forward-looking or prophylactic tool, designed to deter and prevent recidivism and restore trust in the markets." Kara M. Stein, Comm'r, SEC, Remarks at the "SEC Speaks" Conference (Feb. 20, 2015), <http://www.sec.gov/news/speech/022015-spchckms.html>.

16. Daniel M. Gallagher, Comm'r, SEC, Statement on WKSJ Waivers (Apr. 29, 2014), <http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370541680627>.

17. See, e.g., Memorandum, Eben P. Colby, Thomas A. DeCapo & Kenneth E. Burdon, Skadden, Arps, Slate, Meagher & Flom LLP, Disclosure and Collateral Consequences of Enforcement Actions for Regulated Financial Services Firms (Oct. 2, 2014), <https://www.skadden.com/insights/disclosure-and-collateral-consequences-enforcement-actions-regulated-financial-services-firms> (advising on automatic disqualifications of securities enforcement).

18. See, e.g., Jennifer Arlen, *Corporate Criminal Liability: Theory and Evidence*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CRIMINAL LAW 144, 189 (Alon Harel & Keith N. Hylton eds. 2012); see also Drury D. Stephenson & Nicholas J. Wagoner, *FCPA Sanctions: Too Big to Debar?*, 80 FORDHAM L. REV. 775, 807 & n.231 (2011) (discussing the literature on debarments and listing the oft-cited "death penalty" counterargument to debarments); Andrew Weissmann with David Newman, *Rethinking Criminal Corporate Liability*, 82 IND. L.J. 411, 426 (2007) ("A criminal indictment can have devastating consequences for a corporation and risks the market imposing what is in effect a corporate death penalty."); Edward B. Diskant, Note, *Comparative Corporate Criminal Liability: Exploring the Uniquely American Doctrine Through Comparative Criminal Procedure*, 118 YALE L.J. 126, 128–29 (2008) ("[I]t is common wisdom within the business community that a conviction amounts to a potentially lethal blow for a corporation, one from which the corporation may not recover even if it is actually innocent" (citation omitted)); Erik Paulsen, Note, *Imposing Limits on Prosecutorial Discretion in Corporate Prosecution Agreements*, 82 N.Y.U. L. REV. 1434, 1436 (2007) ("When Andersen collapsed after its indictment, federal prosecutors realized that prosecution alone could destroy even the most established of companies."). But see Gabriel Markoff, *Arthur Andersen and the Myth of the Corporate Death Penalty: Corporate Criminal Convictions in the Twenty-First Century*, 15 U. PA. J. BUS. L. 797, 821–25 (2013) (reporting that of fifty-four publicly traded firms that were convicted, only two failed within three years of the convictions, suggesting that a criminal conviction rarely dooms a company).

Rules 505 and 506 of Regulation D, and the automatic shelf registration statement to raise external capital. First adopted in 1940, the bad-actor disqualification was primarily intended to reduce the risk of future violations related to the offer and sale of securities. The SEC has the authority to waive disqualifications on showing of good cause, in particular where the defendant poses a low risk of fraud in a disqualified offering.

The Article reviews the population of 201 bad-actor and ineligible-issuer waivers granted between July 2003 and December 2014, and identifies three significant trends in the SEC's exercise of waiver authority. First, large financial firms and their affiliates received a large majority of waivers, 81.6 percent. Smaller financial firms—those with fewer than one thousand employees—and nonfinancial companies rarely received waivers, even though they were more often targeted in securities enforcement actions.¹⁹ The relative share of waivers issued to large financial firms is not necessarily a reason for concern if such firms are less likely to commit securities fraud than smaller or nonfinancial firms, either because of better self-policing or closer agency oversight. But there is limited evidence of either. Large financial firms also pay larger financial penalties than smaller firms, possibly in lieu of disqualifications.

Second, the study reports that the Commission's decisions regarding waivers lack transparency. The reasoning in waiver grants is formulaic, and the Commission's decisions rely on applicant representations. Moreover, only decisions granting waivers have been made available to the public. Information about denied waiver requests is not available.²⁰ Despite limited information on waiver practices overall, a closer look at the Commission's decisions to grant waivers reveals coherent patterns. Firms charged with offering fraud, i.e., Ponzi schemes, and accounting fraud rarely receive waivers, presumably because a history of such violations indicates higher risk of fraud in disqualified offerings. Most waivers are granted to firms that violated broker-dealer and investment adviser rules. The study suggests that the SEC grants at least some waivers too readily. For example, a relatively high number of waivers were granted to financial firms that packaged and sold Residential Mortgage-Backed Securities ("RMBS"), Collateralized Debt Offerings ("CDO"), and other mortgage securities in violation of securities laws, where a disqualification would have prevented the violation that had triggered it. In addition, some firms appear in the waivers data set a half dozen or more times. Repeat violations suggest a larger problem with compliance and raise doubt about the

19. Cf. Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers*, 67 BUS. LAW. 679, 701 tbls.5a & 5b (2012) (showing a higher number of settlements with small broker-dealer firms than with large broker-dealers).

20. The author submitted a Freedom of Information Act (FOIA) request for requested waivers under Rules 262, 505, 506, and 405, and was informed that the Commission did not collect information about requested waivers.

ability of the firm to self-police—and thus represent a red flag for future violations.

Third, the study reveals a shift in waiver practices over time. The number of granted waivers has declined since 2010, when an investigation by the Office of Inspector General (“OIG”) first revealed concerns that waivers were being used as bargaining chips in settlements of enforcement actions. In addition, the SEC recently abandoned its practice to either grant a waiver in full or deny it. Since the addition of Rule 506(d), the Commission has issued a handful of partial waivers, either limited or conditional. The practice is a welcome development, both to protect investors and to limit the potentially high cost associated with Rule 506(d) disqualifications. The Article concludes by offering several recommendations to improve disqualifications and make waiver decisions more principled and transparent.

Part I provides background on collateral consequences against firms, on securities enforcement, and on automatic disqualifications in securities laws. Part II considers why the law disqualifies firms targeted by securities enforcement actions in addition to imposing direct penalties. It considers two rationales for automatic disqualifications—reducing the risk of repeat misconduct and enhancing the direct sanction. It also considers arguments against automatic disqualifications. Part III reports the results of an empirical investigation into the SEC’s practice regarding disqualifications and waivers from automatic disqualifications. It discusses the many data limitations and summarizes the basic features of waivers. Part IV discusses in greater depth three specific observations: the lower likelihood of waiver where the underlying violation involves accounting or securities offering fraud, the disproportionate share of large financial firms that receive waivers, and the declining number of granted waivers. Finally, Part V proposes modifications to current SEC practices regarding automatic disqualifications. First, the Article proposes that lawmakers and regulatory agencies develop coherent rationales for automatic disqualifications in enforcement actions. Currently, disqualifications attach only to some exemptions in securities laws, but not all, without a principled rationale. Second, agency decisions regarding disqualifications and waivers ought to be transparent and publicly available, and provide meaningful justifications that are consistent with rationales underlying disqualifications. Third, the Article suggests that disqualifications can be useful enforcement tools in appropriate cases, against both large and small firms. Rather than waive all collateral consequences against large financial firms, the Article proposes using limited disqualifications, tailored to protect investors without being overbroad.

I.

COLLATERAL CONSEQUENCES AGAINST ENTITIES IN SECURITIES
ENFORCEMENT

Federal prosecutors have insisted that firms plead guilty and pay ever-larger penalties, but have worked behind the scenes to protect large-firm defendants from collateral consequences that otherwise accompany enforcement actions.²¹ Recently, a growing number of regulators have become disenchanted with the practice and have insisted that large firms ought to suffer the full legal consequences of their misconduct, just like smaller firms and individuals.²²

This Part distinguishes between direct and collateral consequences of enforcement. It catalogues the most significant collateral consequences triggered by securities enforcement and discusses waivers for good cause as well as the impact of disqualifications on affected firms.

A. What Are Collateral Consequences?

Any sanction, whether imposed after a guilty plea or resulting from a settlement of a class action, invariably exceeds the punishment imposed by the court or the consideration of the settlement. Large damages can render an individual or a firm insolvent.²³ Sanctions in public enforcement actions are often greater than those in private suits, in part because the law automatically disqualifies defendants in public enforcement actions from enjoying civil benefits available to others. Different terms have been used to refer to automatic disqualifications triggered by public enforcement, including disabilities and collateral consequences.²⁴

The literature on sanctions distinguishes between *direct* and *collateral* consequences of an enforcement action.²⁵ A consequence is direct if it is imposed by an agency or a court as part of the authorized punishment and is included in the order or judgment, ordinarily after a hearing. The direct consequence can be financial or nonfinancial: prison time, probation, disbarment, fine, disgorgement, restitution, a cease-and-desist order, injunction, or censure. A collateral consequence is an additional burden that is not included in the sanctioning order itself. Rather, it is a legal disability that is

21. See Ben Protess & Jessica Silver-Greenberg, *BNP Admits Guilt and Agrees to Pay \$8.9 Billion Fine to U.S.*, N.Y. TIMES, July 1, 2014, at B1 (quoting U.S. Attorney General Eric Holder's statement that BNP Paribas's guilty plea would send a "strong message" to other firms that illegal conduct will not be tolerated, but observing that prosecutors and regulators had "coordinated their actions months in advance" to limit any collateral consequences that a guilty plea might trigger).

22. See, e.g., Stein, *supra* note 13.

23. That is why doctors and lawyers carry insurance.

24. See, e.g., Colby, DeCapo & Burdon, *supra* note 17 (using both terms).

25. See, e.g., Gabriel J. Chin & Richard W. Holmes Jr., *Effective Assistance of Counsel and the Consequences of Guilty Pleas*, 87 CORNELL L. REV. 697, 713–15 (2002); Walter Matthews Grant et al., *The Collateral Consequences of a Criminal Conviction*, 23 VAND. L. REV. 929 (1970).

triggered upon resolution of a criminal or civil enforcement action. Because collateral consequences are usually imposed automatically by statute or rule, the agency or court does not consider whether they are appropriate for a particular defendant firm.²⁶

Collateral consequences against firms can include a revocation of a license to do business in a state or in a particular industry, such as banking or insurance.²⁷ They can bar an accounting firm from auditing public companies,²⁸ a bank from taking deposits from the public,²⁹ or an investment company from managing its clients' money.³⁰ Collateral consequences can be automatic³¹ or discretionary,³² permanent³³ or temporary.³⁴ Some only marginally increase the cost of doing business,³⁵ while others can have profound effects on the firm, disrupt entire industries, and destabilize global markets.³⁶

B. Direct and Collateral Consequences in Securities Enforcement

Securities enforcement actions against firms impose three types of direct sanctions: orders prohibiting similar violations in the future; monetary sanctions, such as fines and disgorgement orders; and orders suspending or

26. See, e.g., U.S. DEP'T OF JUSTICE, FEDERAL STATUTES IMPOSING COLLATERAL CONSEQUENCES UPON CONVICTION, http://www.justice.gov/pardon/collateral_consequences.pdf (last visited June 21, 2015) (collecting information about collateral consequences of criminal conviction under federal laws); *User Guide Frequently Asked Questions*, ABA NAT'L INVENTORY COLLATERAL CONSEQUENCES CONVICTION, http://www.abacollateralconsequences.org/user_guide (last visited June 21, 2015) (addressing the question "What is the difference between a direct and a collateral consequence of conviction?"). Collateral consequences should not be conflated with other consequences of legal trouble that are not imposed by state action, such as legal fees, harm to reputation, or impaired creditworthiness, which can be significant. See Gabriel J. Chin, *The New Civil Death: Rethinking Punishment in the Era of Mass Conviction*, 160 U. PA. L. REV. 1789, 1792 (2012) (drawing the same distinction).

27. The Comptroller of the Currency may revoke a bank's franchise if the bank is convicted of money laundering or knowingly engaging in monetary transactions in property from unlawful activity. 12 U.S.C. § 93 (2012); 18 U.S.C. §§ 1956–1957 (2012).

28. 17 C.F.R. § 201.102(e) (2014).

29. 12 U.S.C. § 1818(a)(2).

30. 15 U.S.C. § 80a-9 (2012).

31. Statutes that bar felons from voting are automatic. Similarly, most disqualifications in securities regulation are automatic. See discussion *infra* Part I.C.

32. Banking regulators, on the other hand, possess discretionary authority to terminate a banking license. See, e.g., 12 U.S.C. § 93(d)(1)(B).

33. License revocations are often permanent. See *id.* § 93(d).

34. See, e.g., 17 C.F.R. § 230.262 (2015) (imposing a five-year disqualification on firms convicted of securities fraud).

35. See Stein, *supra* note 13 (suggesting that the ineligible-issuer disqualification would have an insignificant impact on a large bank).

36. See Lanny A. Breuer, Assistant Attorney Gen., U.S. Dep't of Justice, Assistant Attorney General Lanny A. Breuer Speaks at the New York City Bar Association (Sept. 13, 2012), <http://www.justice.gov/criminal/pr/speeches/2012/crm-speech-1209131.html> ("I have heard sober predictions that a company or bank might fail if we indict, that innocent employees could lose their jobs, that entire industries may be affected, and even that global markets will feel the effects.").

expelling defendant firms from the securities industry.³⁷ In addition, under federal securities laws, public enforcement actions for securities and financial violations can give rise to numerous collateral consequences, called disqualifications.

These disqualifications are triggered automatically, without a separate hearing and regardless of the severity of the offense.³⁸ Firms and individuals convicted of securities fraud cannot serve as investment advisors, investment fund managers, or fund underwriters for a period of ten years,³⁹ and they cannot receive marketing and referral fees from fund managers for referring clients.⁴⁰ Most importantly for the purposes of this Article, securities laws bar defendant firms and individuals sanctioned for securities fraud, and their affiliates, from relying on safe harbors from the mandatory securities registration requirement,⁴¹ and from taking advantage of relaxed disclosure requirements for large public companies.⁴² These so-called bad-actor and ineligible-issuer disqualifications, related to new offerings of securities, are usually triggered by knowing or intentional misconduct, and eliminate some of the most cost-effective options for raising external capital.⁴³

The first automatic disqualification in federal securities laws was included in a 1940 amendment to Regulation A,⁴⁴ at the time one of the most popular ways to sell securities without registration.⁴⁵ The list of triggering events was

37. See 15 U.S.C. §§ 77t, 78u, 80a-41, 80b-9 (2012).

38. See SEC, DISQUALIFICATION OF FELONS AND OTHER “BAD ACTORS” FROM RULE 506 OFFERINGS AND RELATED DISCLOSURE REQUIREMENTS (Sept. 19, 2013), <http://www.sec.gov/info/smallbus/secg/bad-actor-small-entity-compliance-guide.htm> (listing the categories of enforcement actions that trigger a disqualification).

39. See 15 U.S.C. § 80a-9(a).

40. 17 C.F.R. § 275.206(4)-3 (2015). In addition, entities subject to criminal or civil enforcement actions for securities fraud cannot, for three years thereafter, rely on safe harbor provisions protecting them from private litigation for any misleading forward-looking statements. See 15 U.S.C. §§ 77z-2(b), 78u-5(b).

41. See 17 C.F.R. § 230.262 (disqualification from relying on Regulation A, which provides a mini-public-offering exemption from registration for offerings of up to \$5 million); *id.* § 230.602 (disqualification from relying on Regulation E, which exempts from registration small offerings by small investment companies); *id.* § 230.507 (disqualification from relying on Regulation D, which exempts private offerings if they were sanctioned for failing to file the appropriate paperwork with the SEC); *id.* § 230.505(b)(2)(iii) (disqualification from relying on Rule 505 of Regulation D, which provides for an exemption from registration for private offerings of up to \$5 million); *id.* § 230.506(d) (disqualification from relying on Rule 506 of Regulation D, which provides for an exemption from registration for private offerings with no maximum amount).

42. See *id.* § 230.405 (defining “ineligible issuer” so as to render securities violators ineligible for a particularly relaxed disclosure regime available to large public companies).

43. See, e.g., *id.* § 230.506(d).

44. See Securities Act Release No. 33-2410, 1940 WL 7107 (Dec. 3, 1940) (limiting the availability of Regulation A to issuers, promoters, and affiliates that were not convicted of securities-related crimes within the preceding five years, and were not subject to an injunction related to securities violations within the past three years).

45. Regulation B was more popular from 1935 until 1943, but it was available only for public offerings of undivided interests in oil or gas rights. After 1944, Regulation A became the dominant

expanded in 1953, but has not been meaningfully amended since then; today the disqualification is embodied in Rule 262 of Regulation A.⁴⁶ The second automatic disqualification provision that remains effective today was added to exempt offerings under Rule 505 of Regulation D in 1982.⁴⁷ The Rule 505 disqualification incorporates by reference the list of triggering events and disqualified entities in Rule 262, and so these two disqualification provisions are usually discussed together as bad-actor disqualifications.

In September 2013, a new bad-actor disqualification provision related to private placements under Rule 506 of Regulation D became effective. Regulation D includes three different offering exemptions—under Rules 504, 505, and 506⁴⁸—and until recently, only Rule 505 included a disqualification provision. The newly added Rule 506(d) automatically disqualifies sanctioned issuers from using the Rule 506 private placement exemption, which is the most popular way to sell securities without registration.⁴⁹

The Securities Offering Reform regulation in 2005 added the ineligible-issuer disqualification to the growing list of disqualifications.⁵⁰ The reform created a new class of registered companies called well-known seasoned issuers (“WKSIs”). A WKSI is a large public company that has at least \$700 million in worldwide common equity or \$1 billion in nonconvertible securities other than common equity, or is a majority-owned subsidiary of a WKSI.⁵¹ According to the SEC’s analysis, about 30 percent of listed firms qualify for WKSI status.⁵² WKSIs can sell securities to public investors more quickly by providing less disclosure and without having to wait for the SEC to review

exemption from registration. See J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 § 6:3 (2015).

46. See *id.* § 6:10 n.1.

47. Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11251, 11262, 11266 (Mar. 16, 1982) (codified as amended at 17 C.F.R. pts. 230, 239 (2014)).

48. See Regulation D, 17 C.F.R. §§ 230.500–.508 (2013). The 2013 amendment to Regulation D authorized issuers offering securities under Rule 506(c) to advertise generally—which otherwise is prohibited under Rule 506(b)—so long as all purchasers are accredited investors. Thus, Rule 506 now includes two different types of offerings: under 506(b) and 506(c). See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44771 (July 24, 2013) (codified at 17 C.F.R. pts. 230, 239, 242).

49. See IVANOV & BAUGUESS, *supra* note 11.

50. See Securities Offering Reform, 70 Fed. Reg. 44722 (Aug. 3, 2005) (codified as amended at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 243, 249, 274). The recently amended Regulation A, which authorizes a mini public offering of up to \$50 million, also includes an expanded disqualification provision (compared with the old Regulation A). See Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. 21806 (Apr. 20, 2015) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 240, 249, 260). In addition to already enacted provisions, the SEC has proposed to include an automatic disqualification provision to rules on crowdfunding. See Crowdfunding, 78 Fed. Reg. 66428, 66499 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249).

51. See 17 C.F.R. § 230.405 (defining “well-known seasoned issuer”).

52. Securities Offering Reform, 70 Fed. Reg. at 44727.

their registration statement, unlike other reporting companies.⁵³ Firms subject to securities enforcement are ineligible for WKSII status.⁵⁴

The bad-actor and ineligible-issuer disqualifications are similar but not identical with respect to the events that trigger the disqualification, the entities that are disqualified, and the length of time that a disqualification lasts. Disqualification from Regulation A and Rule 505 of Regulation D (the “old bad-actor disqualification provisions”) is triggered by a criminal conviction for a felony or misdemeanor related to a purchase or sale of securities, or a false filing with the SEC; a stop, refusal, or suspension order related to an offering under Regulation A or Rule 505 of Regulation D (or an investigation related to any of these); or a bar or injunction restraining the issuer, underwriter, or individual from violating securities laws related to the purchase or sale of securities or a false filing with the SEC.⁵⁵ Disqualification also occurs if any of the issuer’s directors, officers, general partners, promoters, or 10 percent owners, or the underwriter’s partners, directors, or officers are subject to such a conviction, order, injunction, or bar.⁵⁶

Disqualification under Rule 506(d) (the “new bad-actor disqualification provision”) is triggered by a broader set of enforcement actions. In addition to the criminal convictions, injunctions, administrative orders, and industry bans covered under Regulation A and Rule 505 of Regulation D, the disqualifying events in Rule 506(d) include SEC cease-and-desist orders related to violations of scienter-based antifraud provisions of the securities laws and to violations of Section 5 of the Securities Act,⁵⁷ and final orders of certain state and federal regulatory authorities.⁵⁸

Finally, the ineligible-issuer disqualification is triggered by a different set of events. By one measure, the set is broader because it includes convictions related to securities, as well as financial and banking violations.⁵⁹ By another, it is narrower because disqualification is triggered only by an injunction, a cease-and-desist order, or a determination that the defendant violated antifraud

53. See 17 C.F.R. §§ 230.415(a)(5), 239.13(d) (permitting “automatic shelf offerings”).

54. See Securities Offering Reform, 70 Fed. Reg. at 44746. But ineligible issuers remain eligible for seasoned-reporting-issuer status. See, e.g., 17 C.F.R. § 230.415(a)(1)(x), (5)(ii) (enabling seasoned reporting companies to file a registration statement only once every three years, preregister securities, and offer them off the shelf when market windows open, but requiring prior SEC review before the registration statement becomes effective). In addition to losing WKSII status, an ineligible issuer also loses the ability to use free-writing-prospectus rules to market its public offering. See *id.* § 230.164(e).

55. See 17 C.F.R. §§ 230.262, .505(b)(2)(iii) (full list of triggering events). The investment-adviser disqualification has a similar list of triggering events, though these are more closely related to the investment management business. See 15 U.S.C. § 80a-9(a) (2012).

56. See 17 C.F.R. § 230.262(b).

57. See *id.* § 230.506(d).

58. *Process for Requesting Waivers of “Bad Actor” Disqualification*, DIV. OF CORP. FIN., SEC (Mar. 13, 2015), <http://www.sec.gov/divisions/corpfin/guidance/262-505-waiver.htm>.

59. Including theft, embezzlement, bribery, and misappropriation. See 17 C.F.R. § 230.405 (defining “ineligible issuer”).

provisions of federal securities laws. By contrast, bad-actor disqualifications are triggered by enforcement actions related to any purchase or sale of securities, as well as false filings with the Commission.⁶⁰

In addition to a different list of triggering events, the ineligible-issuer disqualification is somewhat narrower in scope than bad-actor disqualifications regarding what affiliated entities are disqualified, in addition to the sanctioned entity. Under the ineligible-issuer disqualification, the parent company is disqualified if a subsidiary commits a triggering violation. But a subsidiary itself is not automatically disqualified if only the parent company is sanctioned.⁶¹ By contrast, bad-actor provisions disqualify both ways: disqualification of the parent company disqualifies its subsidiaries (so long as the parent holds 10 or 20 percent of any class of equity), and disqualification of any subsidiary disqualifies the parent.⁶²

As a final distinction, the ineligible-issuer disqualification is shorter in duration than the bad-actor disqualifications. The same securities-related enforcement action can render the issuer ineligible from registering as a WKSI for a period of three years,⁶³ but will make Regulation A and Rules 505 and 506 of Regulation D unavailable for a period of five years.⁶⁴

C. *Waivers from Disqualifications*

To avoid an automatic disqualification, a defendant may request that the SEC waive the disqualification, provided that the defendant shows good cause that the disqualification is not necessary under the circumstances.⁶⁵ Conversations with members of the SEC staff revealed that questions regarding waivers are often raised informally during settlement negotiations,⁶⁶ usually by

60. *See id.* §§ 230.262, .505. Other events not related to enforcement also trigger the ineligible-issuer disqualification, including bankruptcy. *See id.* § 230.405.

61. Majority-owned subsidiaries of a WKSI parent that do not otherwise qualify for WKSI status can issue securities in reliance on the parent's WKSI status. Thus, if the parent loses WKSI status because of a securities violation, the majority-owned subsidiary also loses its derivative WKSI status without having to be separately disqualified. *See id.* § 239.13(d)(iii).

62. *Id.* § 230.506(d).

63. *See id.* § 230.405 (listing, in paragraphs (1)(iv)–(vii) of the definition of “ineligible issuer,” triggering events that disqualify an entity if they have occurred “[w]ithin the past three years”). Triggering events overlap but are not identical, and so an enforcement action can trigger zero, one or more disqualifications.

64. *See id.* §§ 230.262(a)(3), .505(b)(2)(iii), .506(d)(1)(i).

65. *Id.* § 200.30–1(a)(10), (b)(1), (c); *see also* JP Morgan Chase Bank, N.A., CFTC No. 14-01, at 18 (Oct. 16, 2013), <http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfjpmorganorder10163.pdf> (waiving 506(d) disqualification). In addition to a SEC waiver, the authority that issues the order triggering the disqualification can advise that a disqualification should not arise as a consequence of the order. *See id.* § 230.506(b)(2)(iii).

66. OFFICE OF INSPECTOR GEN., SEC, REPORT OF INVESTIGATION: INVESTIGATION OF THE CIRCUMSTANCES SURROUNDING THE SEC'S PROPOSED SETTLEMENTS WITH BANK OF AMERICA, INCLUDING A REVIEW OF THE COURT'S REJECTION OF THE SEC'S FIRST PROPOSED SETTLEMENT AND AN ANALYSIS OF THE IMPACT OF BANK OF AMERICA'S STATUS AS A TARP RECIPIENT 45–46 (2010) [hereinafter *OIG BOFA REPORT*] (reporting that a large bank refused to agree to a settlement of

sophisticated counsel retained by defendant companies, but sometimes by the SEC enforcement staff themselves.⁶⁷

The SEC possesses virtually complete discretion to grant or deny a waiver request. Within the last few years, the SEC has articulated a laundry list of criteria for granting a waiver from an automatic disqualification, including change of control, change of supervisory personnel,⁶⁸ extensive remedial efforts after discovering violations, and significant impact if the waiver request is denied.⁶⁹ An SEC OIG investigation and the results of the study reported in Part IV suggest that there exist unwritten “traditional and objective criteria”⁷⁰ that the SEC uses to grant waivers, but the SEC has yet to articulate specific criteria in individual decisions on waivers.⁷¹

The Commission has delegated the authority to grant waiver requests to the Division of Corporation Finance (“Division”), which issues waivers from the bad-actor and ineligible-issuer disqualifications in the form of no-action letters.⁷² No-action letters assure defendants that they will not be prosecuted by the SEC for issuing or underwriting securities on the basis of exemptions that would, in the absence of the waiver, be unavailable to them. Despite the delegation, each Commissioner has the right to pull back any waiver decision and request that the Commission take a vote.⁷³

an enforcement action unless it received a waiver from the WKSJ disqualification); *see also Process for Requesting Waivers*, *supra* note 58 (explaining that the Commission has retained authority to grant waivers “in connection with settling a Commission enforcement action”).

67. One interviewee, who used to work at the Division of Enforcement, reported asking a defendant company, “Have you requested a waiver from the ineligible-issuer disqualification?” The interviewee provided this information on the condition that he or she not be identified.

68. Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings, 78 Fed. Reg. 44730, 44748 (July 24, 2013) (codified at 17 C.F.R. pts. 200, 230, 239 (2014)). The final rule includes in the list of good causes for granting a waiver “absence of notice and opportunity for a hearing.” *See id.* The inclusion is curious since bad-actor disqualifications are always triggered automatically, without an opportunity for a hearing.

69. *See* Div. of Corp. Fin., SEC, Revised Statement on Well-Known Seasoned Issuer Waivers (Apr. 24, 2014), <http://www.sec.gov/divisions/corpfin/guidance/wksi-waivers-interp-031214.htm>; *Waivers of Disqualification Under Rules 505 and 506 of Regulation D*, DIV. OF CORP. FIN., SEC (Mar. 13, 2015), <http://www.sec.gov/divisions/corpfin/guidance/disqualification-waivers.shtml>.

70. OIG BOFA REPORT, *supra* note 66, at 53. One such criterion is that an issuer sanctioned for accounting fraud cannot receive a WKSJ waiver. *See id.* at 56 (noting that Bank of America did not qualify for a WKSJ waiver because “BofA’s alleged fraud was related to its own disclosures”).

71. In a recent effort to increase transparency, the Division of Corporation Finance released a statement providing additional criteria for waivers of Rule 505 and 506 disqualifications. The criteria track those for waivers from the ineligible-issuer disqualification. *See* Div. of Corp. Fin., Revised Statement, *supra* note 69.

72. The Division of Corporation Finance delegated authority to issue waivers from Rule 505, 506(d), and 262 disqualifications to the Office of Small Business Policy, while waivers from the ineligible-issuer disqualification are issued by the Office of Enforcement Liaison. *See Overview of the Legal, Regulatory and Capital Markets Offices*, DIV. OF CORP. FIN., SEC (Mar. 5, 2014), <http://www.sec.gov/divisions/corpfin/cflegalregpolicy.htm> (describing the functions of the Office of Small Business Policy and the Office of Enforcement Liaison).

73. Decisions on waivers from Rule 506(d) and ineligible-issuer disqualifications have recently been made almost exclusively by the Commission, not the Division of Corporation Finance.

D. The Significance of Bad-Actor and Ineligible-Issuer Disqualifications

Direct sanctions in securities enforcement are often serious, and can include multimillion-dollar fines and a permanent ban from the industry, “the harshest penalty available to the Commission.”⁷⁴ By contrast, automatic disqualifications in securities laws usually have only modest consequences, though their impact varies widely depending on the nature and the competitiveness of the defendant firm’s business.⁷⁵ *Ceteris paribus*, the more heavily the defendant firm relies on external capital markets, the more painful the disqualification.

To understand the significance of bad-actor and ineligible-issuer disqualifications, one needs to understand how firms raise money to fund their projects and activities. Generally speaking, firms rely on internal and external sources of capital.⁷⁶ If a firm generates surplus cash, it is the cheapest source of capital and the easiest for management to get its hands on. Surplus cash, usually called retained earnings, has sometimes been described as “free cash flow” because there is no apparent direct cost of using profits made in one period to fund investments in a subsequent period, and managers are often blind to the opportunity cost.⁷⁷ By contrast, external capital, whether debt or equity, comes with restrictions. Debt service requires periodic interest payments, imposes limits on business activities through loan covenants, and subjects the firm to lenders’ oversight. Issuing new equity dilutes current shareholders and lowers earnings per share. Moreover, unlike interest payments, which are tax-deductible, the company must pay taxes on dividends

See, e.g., In re Citigroup Global Markets, Inc., Securities Act Release No. 9657 (Sept. 26, 2014), <http://www.sec.gov/rules/other/2014/33-9657.pdf>; *see also Process for Requesting Waivers*, *supra* note 58 (“The Commission itself retains authority to grant Regulation A and D waivers, including granting them in connection with settling a Commission enforcement action.”)

74. Gadinis, *supra* note 19, at 691.

75. The discussion that follows notwithstanding, some disqualifications have significant consequences all of the time, such as the disqualification from registering as an investment adviser, while others have significant consequences some of the time, such as the newest addition in Rule 506(d). *See, e.g.,* Letter from Thomas J. Kim, Sidley Austin LLP, to Sebastian Gomez Abero, Chief, Office of Small Bus. Policy, Div. of Corp. Fin., SEC, Waiver Request of Oppenheimer & Co., Inc. with Respect to *In the Matter of Oppenheimer & Co. Inc.* 6–7 (Dec. 10, 2014) [hereinafter Oppenheimer Waiver Request], <http://www.sec.gov/divisions/corpfin/cf-noaction/2015/oppenheimer-121014-506d.pdf> (noting that, if disqualified, Oppenheimer could no longer serve as general partner in hedge funds and private equity vehicles, and could lose millions in fees). But speaking generally, disqualifications in securities laws have modest consequences compared with losing a banking license, for example.

76. *See* Michael Sperry, *Equity Capital: The Least Amount of Money Owners Can Invest in a Business and Still Obtain Credit*, in ANALYSIS FOR FINANCIAL MANAGEMENT 203, 203–04 (Robert Higgins ed., 11th ed. 2015).

77. *See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323–24 (1986).

paid to its shareholders. As a result, to the extent they can, managers usually prefer to rely on retained earnings before resorting to external capital markets.⁷⁸

When managers must turn to external markets for capital, they have several alternatives. A company can borrow money from a bank or a syndicate of banks without implicating securities laws at all.⁷⁹ But, loans can be expensive, can impose covenants limiting a borrower's activities, and can shift power from managers to lenders.⁸⁰ Alternately, the firm can issue securities—stocks or bonds. If a firm wants to sell securities to the general public, it must do so through a registered public offering, which is subject to close SEC supervision, serious disclosure requirements, and strict liability for any material misrepresentations or omissions. If the issuer wants to avoid registration, it can sell securities in an exempt offering, by complying with a statutory exemption or a regulatory safe harbor provision.

Although companies' public offerings often capture newspaper headlines,⁸¹ firms raise considerably more capital through exempt, or private, offerings.⁸² There are several types of private offerings, often described as exempt offerings because they are exempt from registration requirements. The most popular exemptions are those provided by Rule 506 of Regulation D, and Rule 144A's exemption for resales to large institutions.⁸³ Less commonly used exemptions include the intrastate exemption under Section 3(a)(11) of the Securities Act, or Rule 147, Rules 504 and 505 of Regulation D, Regulations A and S, the difficult-to-satisfy Section 4(a)(2) of the Securities Act of 1933, and a handful more.⁸⁴ What exempt offerings have in common is that they can be completed quickly, with little or no regulatory oversight, and usually with

78. Managers will turn to external markets when their stock and debt are overpriced, during an industry or asset bubble, for example, or to signal quality by subjecting themselves to external monitoring, or to effect a leveraged transaction and lower agency costs, among other reasons. *See id.* at 324–25.

79. *See, e.g.,* Elisabeth de Fontenay, *Do the Securities Laws Matter? The Rise of the Leveraged Loan Market*, 39 J. CORP. L. 725, 727 (2014).

80. *See* Anthony J. Casey, *The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement*, 124 YALE L.J. 2680 (2015) (discussing various mechanisms that lenders use to monitor and manage debtor firms). *But see* de Fontenay, *supra* note 79, at 744–46 (describing a rise in “covenant-lite” leveraged loans).

81. *See, e.g.,* Shayndi Rice et al., *Facebook Prices IPO at Record Value*, WALL ST. J. (May 17, 2012), <http://www.wsj.com/articles/SB10001424052702303448404577409923406193162>; Vinu Goel, *Taking Flight at Last: Twitter Saunters, But I.P.O. Soars*, N.Y. TIMES, Nov. 7, 2013, at B1.

82. In 2012, companies raised \$1.2 trillion in public offerings and \$1.7 trillion in private offerings. IVANOV & BAUGUESS, *supra* note 11, at 8–9.

83. *See id.* at 9. Rule 144A is technically an exemption from restrictions on resale of restricted securities, but is effectively an offering exemption. The difference is that the issuer sells securities to an investment bank which immediately resells those securities in reliance on Rule 144A. The only reason that the bank is willing to purchase such securities is because of the resale exemption.

84. Regulation E is very similar to Regulation A and exempts from full-blown registration offerings of up to \$5 million made by small investment companies, but still requires a disclosure document and SEC oversight. *See* 17 C.F.R. § 230.601–610 (2015). Regulation S is available only to foreign issuers, *see id.* § 230.901, and Rule 147 exempts from registration offerings within a single state, which are subject to state securities regulation, *see id.* § 230.147.

minimal or no disclosure requirements.⁸⁵ This lowers the cost of raising capital for firms, but also considerably increases the risk of securities fraud.⁸⁶

Not all offering exemptions include disqualification provisions: Regulation A and Rules 505 and 506 of Regulation D do, but Rule 144A, Rule 504 of Regulation D, Regulation S, and Section 4(a)(2) do not. These latter exemptions remain available even for disqualified issuers. Offering exemptions affected by the old bad-actor disqualification provisions, Regulation A and Rule 505 of Regulation D, are among the least-used offering exemptions in recent times. Regulation A has never been particularly popular.⁸⁷ Capped at a low amount, which was raised to \$5 million in 1992,⁸⁸ Regulation A offerings peaked in 1955, when issuers filed 1,638 Form 1-As.⁸⁹ Since 1996, when the National Securities Markets Improvement Act preempted state regulation of Rule 506 offerings but not of Regulation A offerings,⁹⁰ Regulation A offerings have largely become extinct. In 2011, nineteen Regulation A offering statements were filed and only one offering was completed,⁹¹ compared with more than eighteen thousand completed offerings pursuant to Regulation D during the same year.⁹² Amendment to Regulation A, adopted in March 2015, is widely expected to increase the exemption's popularity among small businesses. As Regulation A becomes a more prominent method of raising capital, disqualification from Regulation A will likewise become more consequential.

85. For example, so long as buyers are accredited, Rule 506 does not require the issuer to make any disclosures. 17 C.F.R. § 230.506(b), (c); *see also* Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 *FORDHAM L. REV.* 3389, 3419 (2013).

86. *See, e.g.*, Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 *DEL. J. CORP. L.* 151 (2010) (arguing that Rule 506 private placements that are exempt from both state and federal regulatory review are particularly ripe for abuse); Depository Trust & Clearing Corporation, Comment Letter on Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings (July 14, 2011), <http://www.sec.gov/comments/s7-21-11/s72111-23.pdf> ("[C]ertain exempt offerings . . . present problems in terms of fraud on the investing public. . . . Unfortunately, all too often, such exempt offerings have been used . . . to circumvent the disclosure requirements of the securities laws . . . , in order to introduce securities . . . which should not properly be in the system.").

87. *See* Rutherford B. Campbell, Jr., *Regulation A: Small Businesses' Search for "A Moderate Capital,"* 31 *DEL. J. CORP. L.* 77, 82 (2006) (reporting that "small businesses almost never utilize Regulation A as a way to raise external capital"). Regulation A has been available since 1936. Its use peaked between 1946 and 1956, when issuers completed over one thousand Regulation A offerings per year. It has declined steadily since then. *See* HICKS, *supra* note 45, § 6:3 & tbl.2.

88. *See* Small Business Initiatives, 57 *Fed. Reg.* 36442, 36468 (Aug. 13, 1992) (codified as amended at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 249, 260).

89. *See* HICKS, *supra* note 45, § 6:3 & tbl.2.

90. Pub. L. No. 104-290, § 102(a), 110 *Stat.* 3416, 3417-20 (1996) (codified at 15 U.S.C. § 77r (2015)) (amending section 18(b)(4)(D) of the Securities Act).

91. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-839, *SECURITIES REGULATION: FACTORS THAT MAY AFFECT TRENDS IN REGULATION A OFFERINGS* 9 (2012), <http://www.gao.gov/assets/600/592113.pdf>.

92. IVANOV & BAUGUESS, *supra* note 11, at 4.

Rule 505 of Regulation D is similarly unpopular; it is the least used of the three Regulation D exemptions.⁹³ Between 2009 and 2012, nonfinancial companies completed 934 offerings under Rule 505 and raised about \$3.4 billion. During the same time, nonfinancial companies completed 40,752 offerings under Rule 506 of Regulation D and raised \$3.4 trillion.⁹⁴ The reasons for the relative popularity of Rule 506 are easy to identify. Unlike offerings under Rules 504 and 505 of Regulation D, which are capped at \$1 million and \$5 million respectively, Rule 506 has no cap. More importantly, offerings completed under Rule 506 are exempt from state securities regulation as well as from section 12(a)(2) liability, whereas offerings under Rules 504 and 505 are not.⁹⁵ Seventy-seven percent of offerings under Rule 506 raised less than \$5 million, suggesting that companies prefer to rely on the Rule 506 safe harbor even when Rule 505 is an option.⁹⁶

The Rule 506(d) disqualification provision is thus very consequential for issuers, investment banks, and, in particular, private pooled vehicles, such as hedge funds, private equity funds, and venture funds, which rely heavily on Rule 506 to raise funds.⁹⁷ Without the ability to rely on the Rule 506 private placement exemption, disqualified firms must use alternatives that are considerably more cumbersome and costly, such as Section 4(a)(2) of the Securities Act,⁹⁸ a registered public offering, or an offering under Regulation S that is limited to foreign investors.⁹⁹ A disqualified investment bank cannot participate in private offerings as solicitor or placement agent in Rule 506 offerings for hedge funds and other private funds.¹⁰⁰ Although the market for underwriting private placements is relatively small,¹⁰¹ a disqualified investment bank is likely to lose private funds as advisory clients if it cannot underwrite its

93. See *id.* at 7–8 (showing that between 2009 and 2012, nonfinancial firms completed more than forty thousand offerings under Rule 506, 1,997 offerings under Rule 504, and 934 offerings under Rule 505).

94. *Id.* at 4, 7–8.

95. Professor Johnson has asserted that Rule 506 offerings operate in a “regulatory vacuum,” where they escape both state and federal regulatory review. Johnson, *supra* note 86, at 151.

96. IVANOV & BAUGUESS, *supra* note 11, at 7–8.

97. See *id.* at 11; see also Oppenheimer Waiver Request, *supra* note 75, at 6–7 (noting that, if disqualified, Oppenheimer could no longer serve as general partner in hedge funds and private equity vehicles). The SEC has recently ramped up enforcement against private funds. See Andrew J. Bowden, Dir., Office of Compliance Inspections & Examinations, SEC, Address at Private Equity International Private Fund Compliance Forum: Spreading Sunshine in Private Equity (May 6, 2014), <http://www.sec.gov/News/Speech/Detail/Speech/1370541735361>.

98. In recent years, firms completed between 518 and 863 private placements per year under Section 4(a)(2) exemption. See IVANOV & BAUGUESS, *supra* note 11, at 9.

99. While foreign offerings remain a viable option for disqualified issuers, shares sold in such offerings are restricted and sell at a considerable discount. See Stephen J. Choi, *The Unfounded Fear of Regulation S: Empirical Evidence on Offshore Securities Offerings*, 50 DUKE L.J. 663, 710 (2000) (reporting that Regulation S offerings are issued at an average 16.46 percent discount).

100. See IVANOV & BAUGUESS, *supra* note 11, at 7.

101. See *id.* at 16–17 (“Only 13% of all new [Regulation D] offerings since 2009 use an intermediary such as a finder or broker-dealer.” (citation omitted)).

clients' offerings, as well as customers who want to invest in such funds.¹⁰² Because the disqualification is triggered automatically upon sanction for securities fraud, the SEC never considers whether such disqualification is appropriate for a particular defendant firm unless it issues a waiver.

The only disqualification provision that applies to public offerings is the ineligible-issuer disqualification. Because of close SEC oversight and sweeping liability provisions, public offerings are generally considered low-risk for securities fraud. But in 2005, the SEC carved out an exception for public offerings by WKSIs, such as Citigroup, Walmart, and Apple.¹⁰³ Because investors and the securities industry pay close attention to these companies, there is presumably less need for SEC oversight. WKSIs are allowed to preregister offerings with the SEC by filing an "automatic shelf registration statement," which does nothing more than notify the SEC and the general public that the company might, at some point in the future, issue an unspecified amount of unspecified securities.¹⁰⁴ This type of offering allows the largest public companies to literally sell securities "off the shelf" when market conditions are optimal and comply with regulatory disclosure requirements only after the offering has been completed.¹⁰⁵ The SEC never reviews automatic shelf offerings before the sale and only rarely afterwards.¹⁰⁶ Thus, a WKSI can complete a public offering within a day or two (as opposed to the standard four months that it takes to complete an Initial Public Offering), in a process that bears close resemblance to private placements under Rule 506. Without WKSI status, the firm must comply with regular registration rules for accelerated filers that slow down the offering and subject it to closer SEC scrutiny.¹⁰⁷ In addition, the firm loses the right to rely on the free-writing-prospectus provisions under Rules 164 and 433 to market the offering.¹⁰⁸ Similar to the old bad-actor disqualifications, the ineligible-issuer disqualification marginally increases the cost of raising capital for the

102. See Oppenheimer Waiver Request, *supra* note 75, at 7 ("Oppenheimer believes that there is a real risk that clients who want to invest in alternative investments after the Order is issued would leave the Firm if Oppenheimer can no longer offer alternative investments to them.").

103. Securities Offering Reform, 70 Fed. Reg. 44722, 44727–28 (Aug. 3, 2005) (codified as amended at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 243, 249, 274).

104. 17 C.F.R. § 230.415(a)(5) (2014).

105. See *id.* § 230.430B(a). Verizon's shelf registration before its large debt offering in the fall of 2013 is a good example of a barebones automatic shelf registration statement. See Verizon Communications Inc., Registration Statement (Form S-3) (Sept. 3, 2013), <http://www.sec.gov/Archives/edgar/data/732712/000119312513354742/d587387ds3asr.htm>.

106. According to an internal study, the SEC reviews 10 percent of automatic shelf registration statements. Lloyd S. Harnetz & Bradley Berman, Morrison & Foerster LLP, Frequently Asked Questions About Shelf Offerings (2015), <http://media.mofo.com/files/Uploads/Images/FAQShelfOfferings.pdf>.

107. Usually, the firm files a regular shelf registration statement after settlement of an enforcement action. SEC action is required before the shelf registration statement becomes effective. 17 C.F.R. § 230.415(a)(5).

108. *Id.* § 230.164.

sanctioned firm and puts it “at a competitive disadvantage,”¹⁰⁹ but does not otherwise threaten the firm’s viability.¹¹⁰

II.

WHY DISQUALIFY?

The history of collateral consequences is a history of path dependence.¹¹¹ Civil disabilities resulting from criminal convictions of individuals were originally intended to shame and ridicule,¹¹² and to exclude felons.¹¹³ Retributive justifications for individual punishment do not apply easily to firms, which have “no soul to be damned, and no body to be kicked.”¹¹⁴

Like criminal law, securities law has included disqualification provisions for decades. Historically, state agencies barred market participants from selling securities if they had previously been sanctioned for securities-related offenses. The practice traces its origins to merit review, which remains the dominant approach in state securities regulation (as opposed to disclosure-based federal securities regulation).¹¹⁵ When conducting merit review, the securities regulator reviews the issuer and the offering to prevent fraudulent securities offerings.¹¹⁶ The securities regulator will deny registration and stop the offering unless it deems the issuer and its securities offering worthy and fair. Former offenders—

109. OIG BOFA REPORT, *supra* note 66, at 45.

110. For example, Citigroup settled an enforcement action involving an issuer reporting and disclosure violation, which triggered an ineligible-issuer disqualification. Citigroup did not receive a waiver and was disqualified from using its WKSJ status for three years. See Andrew Ackerman, *SEC Grants Citigroup Waivers, Easing Hedge-Fund Curbs*, WALL ST. J. (Sept. 30, 2014, 9:39 PM), <http://www.wsj.com/articles/sec-grants-citigroup-waivers-easing-hedge-fund-curbs-1412101382>.

111. See Grant et al., *supra* note 25, at 950 (suggesting that collateral consequences exist in America because of the “unquestioning adoption of the English penal system by our colonial forefathers and the succeeding generations who continued existing practices without evaluation”).

112. Mirjan R. Damaska, *Adverse Legal Consequences of Conviction and Their Removal: A Comparative Study*, 59 J. CRIM. L. CRIMINOLOGY & POL. SCI. 347, 351 (1968).

113. Nora V. Demleitner, *Preventing Internal Exile: The Need for Restrictions on Collateral Sentencing Consequences*, 11 STAN. L. & POL’Y REV. 153, 153 (1999) (“An increasing number of mandatory exclusions from the labor force and governmental programs have followed a temporary decrease of some collateral consequences during the 1960s and early 1970s.”); Grant et al., *supra* note 25, at 941.

114. John C. Coffee, Jr., “No Soul to Damn: No Body to Kick”: *An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 386 (1980) (quoting Edward, First Baron Thurlow).

115. See SEC, REPORT ON THE UNIFORMITY OF STATE REGULATORY REQUIREMENTS FOR OFFERINGS OF SECURITIES THAT ARE NOT “COVERED SECURITIES” (Oct. 11, 1997), <https://www.sec.gov/news/studies/uniformy.htm> (reporting that “approximately 40 states apply a ‘merit review’ approach”). Few remember today that the original draft of federal securities laws proposed merit review of securities offerings. See S. 875, 73d Cong. § 6(c), (e), (f) (1933), reprinted in 3 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item 28, at 12–13 (J.S. Ellenberger & Ellen P. Mahar eds., 1973) (authorizing revocation of an issuer’s registration upon a finding that the issuer “is in any other way dishonest” or “in an unsound condition or insolvent”).

116. SEC, REPORT ON THE UNIFORMITY OF STATE REGULATORY REQUIREMENTS, *supra* note 115.

bad actors—are presumptively unworthy and are disqualified to protect investors.¹¹⁷

By contrast, federal securities laws are often described as a disclosure-based regime, where the regulator’s primary goal is not to evaluate the fairness of an offering but to ensure accurate and complete disclosure to let investors make fully informed purchasing decisions. Automatic disqualifications based on the worthiness of the issuer are inconsistent with a disclosure-based regime: disclosure of past enforcement actions should be sufficient. But the federal regime has not been exclusively disclosure-based for decades,¹¹⁸ and federal securities laws have included automatic disqualification provisions from safe harbors for specific private offerings since at least 1940.¹¹⁹ These provisions were adopted “to protect investors and the markets from ‘bad actors.’”¹²⁰

The legal provisions are short, but the literature on collateral consequences suggests two possible rationales for withholding safe harbor provisions from bad actors: reducing the risk of future misconduct¹²¹ and enhancing sanctions.¹²²

A. Reducing Recidivism

Offerings associated with disqualifications—automatic shelf offerings and exempt offerings under Rules 505 and 506 of Regulation D, and Regulation A—can be completed quickly, with minimal disclosure before the sale and minimal agency oversight. This combination leaves investors particularly vulnerable. And so, prophylactic disqualifications can be an appropriate mechanism to protect investors and the markets from bad actors.¹²³

Senator Dodd, the original proponent of the Rule 506(d) disqualification provision, explained that his primary motivation was to prevent “felons and

117. See HICKS, *supra* note 45, § 6:10.

118. See, e.g., Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (codified in scattered sections of 15 U.S.C.) (requiring issuers to maintain a system of internal controls); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C.) (requiring public firms to have a fully independent audit committee).

119. See Securities Act Release No. 33-2410, 1940 WL 7107 (Dec. 3, 1940).

120. Stein, *supra* note 13.

121. MARGARET COLGATE LOVE ET AL., COLLATERAL CONSEQUENCES OF CRIMINAL CONVICTIONS: LAW, POLICY, AND PRACTICE § 1:2 (2013); see also Chin, *supra* note 26, at 1808 (explaining that the underlying reason for collateral consequences may be “to protect public safety or to promote some other aspect of the public interest”).

122. See PATTI B. SARIS ET AL., U.S. SENTENCING COMM’N, GUIDELINES MANUAL §§ 5E1.2(d)(5), 8C2.8(a)(3) (directing the court to consider collateral consequences of conviction when determining the appropriate fine against an individual or an organization); Chin & Holmes, *supra* note 25, at 700 (asserting that collateral consequences of a guilty plea “operate as a secret sentence”); Paul W. Tappan, *The Legal Rights of Prisoners*, 293 ANNALS AM. ACAD. POL. & SOC. SCI. 99, 109 (1954) (explaining that disqualifications “may be conceived to be either an auxiliary punishment” or “protective of public interests,” but concluding that “they . . . appear very frequently to reflect retributive sentiments rather than any real need for community protection”).

123. Stein, *supra* note 13.

other ‘bad actors’ who have violated Federal and State securities laws from continuing to take advantage of the rule 506 private placement process . . . [to] *reduce the danger of fraud in private placements.*”¹²⁴ SEC Commissioner Luis Aguilar similarly explained that the Rule 506(d) bad-actor provision would protect investors from “fraudsters and other recidivists.”¹²⁵

Although it has long been its unwritten practice, the SEC’s Division of Corporation Finance, which grants the vast majority of waivers from automatic disqualifications, only recently articulated that it views reducing the risk of recidivism as the primary reason for disqualifications.¹²⁶ In deciding whether to waive a disqualification, the Division considers whether prior misconduct signals a higher likelihood of future fraud in an offering of securities, whether the firm has taken steps to remedy deficiencies that led to the original violation, and whether the firm is likely to produce more reliable disclosures in the future.¹²⁷

Automatic disqualifications in securities regulation are thus premised on a particular theory: that firms sanctioned for knowingly violating certain provisions of securities laws, in particular those relating to accounting fraud and fraudulent disclosure in securities offerings, are more likely to repeat similar violations in the future.¹²⁸ Because they pose a higher risk of fraud, sanctioned firms should not be allowed to rely on capital-raising options under securities laws that minimize disclosure requirements, rely on trusting the issuers, and depend on investors to police issuers. By contrast, firms that violate merely “technical” securities rules are less likely to defraud investors in future securities offerings, and so disqualifications are not triggered. An example of a technical violation is Rule 105 of Regulation M, which prohibits underwriters in public offerings of equity securities from shorting those securities during a restricted period before the public offering.¹²⁹ Liability under Rule 105 is strict and thus does not trigger automatic disqualifications.¹³⁰

124. Disqualification of Felons and Other “Bad Actors” From Rule 506 Offerings, 76 Fed. Reg. 31518, 31530 & n.93 (proposed June 1, 2011) (codified as amended at 17 C.F.R. pts. 200, 230, 239 (2015) (emphasis added)); *see also* Press Release, U.S. House Comm. on Fin. Servs., Waters Unveils Legislation to Reform Waiver Process at the SEC (Mar. 24, 2015), <http://democrats.financialservices.house.gov/news/documentsingle.aspx?DocumentID=398924>.

125. Luis Aguilar, Comm’r, SEC, Limiting—But Not Eliminating—Bad Actors from Certain Offerings (July 10, 2013), <https://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370543418576>.

126. *See* OIG BOFA REPORT, *supra* note 66, at 53, 56–57 (2010) (referring to “traditional and objective criteria” that a WCSI waiver cannot be granted if the fraud was related to defendant firm’s own disclosures); Div. of Corp. Fin., Revised Statement, *supra* note 69.

127. *See* Div. of Corp. Fin., Revised Statement, *supra* note 69.

128. *See id.*

129. 17 C.F.R. § 242.105 (2015). The prohibition aims to prevent investors from artificially depressing stock prices by aggressively selling short just before the offering, and covering their short sales by buying newly issued stock at depressed prices. Such manipulative rent-seeking behavior by investors would reduce proceeds from the offering and thereby raise the cost of capital for issuers.

130. *See id.* In addition to lacking a scienter requirement, the rule appears to have no materiality threshold, as evidenced by the SEC bringing enforcement actions for violations that resulted in only

The theory that only some securities violations are correlated with higher risk of producing false disclosures is a falsifiable proposition for which we have very little empirical evidence.¹³¹ There is some evidence suggesting that, if given the opportunity, fraudsters tend to commit fraud again. For example, one state securities regulator observed that a “small minority of bad brokers—and brokerage firms—does a tremendous amount of damage.”¹³² If so, it seems plausible in theory that bad-actor and ineligible-issuer disqualifications would reduce the likelihood of misconduct. Private placement exemptions are particularly ripe for abuse, and so a disqualification would appear appropriate for individuals and firms that defrauded investors in the past.

But the proposition is both over- and underinclusive. We do not know whether all or only a minority of securities offenders are hardened recidivists.¹³³ If few are likely to defraud investors again, automatic disqualifications are overbroad. Moreover, some types of offenses are probably better predictors for future fraud than others. For example, Ponzi schemers are often recidivists. Several were convicted or sanctioned for securities fraud before they started a Ponzi scheme.¹³⁴ On the other hand, a broker-dealer that cherry-picks securities *probably* does not pose the same risk of fraud in a disqualified offering. Yet both enforcement actions would trigger disqualifications.¹³⁵

At the same time, disqualifications are underinclusive. We do not know whether and which specific securities violations predict the likelihood of offering fraud or accounting fraud. Does a history of accounting fraud pose a higher risk of fraud to investors than manipulative mutual fund or broker-dealer

\$4,091 in profits. See John M. Loder, *SEC Enforcement Focusing on Rule 105 of Regulation M*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 2, 2013, 9:20 AM), <http://blogs.law.harvard.edu/corpgov/2013/11/02/sec-enforcement-focusing-on-rule-105-of-regulation-m>.

131. Admittedly, the question is nearly impossible to study. A large majority of securities violations are never detected. Moreover, enforcement levels vary from year to year, with each Chair furthering her own enforcement agenda, and so one cannot use enforcement actions as proxies for rates of misconduct. See JORGE BAEZ ET AL., NERA ECON. CONSULTING, SEC SETTLEMENT TRENDS: 2H12 UPDATE 19–24 (2013) (comparing settlement trends under Mary Schapiro’s chairmanship with those before).

132. Jean Eaglesham & Rob Barry, “*Cockroaching*”: *Brokers Bounce from Troubled Firm to Troubled Firm*, WALL ST. J., Oct. 4, 2013, at A1 (quoting Denise Voigt Crawford, former securities commissioner of the Texas State Securities Board). Brokers associated with firms in trouble usually move on to similarly troubled firms, where they continue to engage in shady practices. See *id.*

133. Evidence from FINRA’s oversight of brokers suggests that even among sanctioned brokers, a tiny minority can properly be described as recidivists. Of 70,765 brokers with customer complaints or sanctions, less than 5 percent (3,115) had five or more items. See Jean Eaglesham & Rob Barry, *Finra Is Cracking Down on ‘High-Risk’ Brokers*, WALL ST. J. (Nov. 21, 2013), <http://www.wsj.com/articles/SB10001424052702304607104579212321072458370>.

134. See, e.g., Complaint, SEC v. Mowen, No. 2:09cv00786, 2012 WL 2120249 (D. Utah June 11, 2012), <https://www.sec.gov/litigation/complaints/2009/comp21196.pdf> (several convictions for securities fraud and theft); Complaint, SEC. v. Judah, No. 5-09CV0087-C, 2009 WL 1948455 (N.D. Tex. Apr. 21, 2009), <https://www.sec.gov/litigation/complaints/2009/comp21009.pdf> (SEC enforcement action for violations of securities-registration and antifraud provisions of securities laws).

135. Assuming that the SEC adds an injunction in the broker-dealer settlement.

practices?¹³⁶ The answer is not obvious. Both types of misconduct stem from a failure of compliance. Any securities violation signals an indifference to rules and suggests higher risk for future misconduct.¹³⁷ Evidence discussed in Part IV.A suggests that the Commission and the Division of Corporation Finance consider accounting fraud and, to a lesser extent, securities offering fraud as predictors of future fraud.

Evidence discussed in Part IV.B suggests that the SEC treats large financial firms differently than small financial firms and nonfinancial firms.¹³⁸ If disqualifications are prophylactic measures, the only reason for different treatment of similar offenses is the existence of factors that mitigate the risk of securities fraud when the defendant firm is large. An example would be an alternative oversight regime that generally reduces the risk of fraud in disqualified offerings, including closer agency oversight or other external scrutiny and self-policing. But defendants' waiver requests and the SEC's waiver decisions suggest that the Division and the Commission consider the existence of alternative risk-reduction measures only in a cursory fashion.

There is also a practical difficulty with using disqualifications to reduce recidivism: they are difficult to enforce. No central repository aggregates relevant information from all federal and state courts and regulatory authorities to determine whether individuals or firms have a disqualifying event in their past.¹³⁹ In fact, the SEC does not keep a record of disqualified firms and individuals.¹⁴⁰ Even where regulatory organizations keep records, these records are often incomplete and misleading.¹⁴¹ The Rule 506(d) disqualification

136. See discussion *infra* Part IV.A.1 (showing that issuers charged with accounting fraud are regularly disqualified, while broker-dealers who skimmed from their customers often receive waivers).

137. See, e.g., Luis M. Aguilar & Kara M. Stein, Comm'rs, SEC, Dissenting Statement in the Matter of Oppenheimer & Co., Inc. (Feb. 4, 2015), <http://www.sec.gov/news/statement/dissenting-statement-oppenheimer-inc.html> (dissenting from a waiver grant to Oppenheimer and citing more than thirty separate regulatory actions to suggest that Oppenheimer is likely to violate securities laws again). In addition, there is some awareness in the D&O insurance industry that the tone set at the top is an important determinant for the propensity of lower-level employees toward misconduct. See Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 517–25 (2007) (describing that informal norms toward compliance, as opposed to defection, and the attitude toward excessive risk taking are at least as important as formal rules in predicting the likelihood of misconduct).

138. See discussion *infra* Part IV.B.

139. See Disqualification of Felons and Other “Bad Actors” From Rule 506 Offerings, 78 Fed. Reg. 44730, 44746 (July 24, 2013) (codified at 17 C.F.R. pts. 200, 230, 239 (2015)).

140. Interview with SEC official. The official provided this information on the condition that he or she not be identified.

141. See, e.g., Jean Eaglesham & Rob Barry, *Stockbrokers Fail to Disclose Red Flags*, WALL ST. J. (Mar. 5, 2014), <http://www.wsj.com/articles/SB10001424052702304026804579411171593358690> (explaining that FINRA offers investors a verification services called BrokerCheck, but finding that brokers regularly fail to disclose criminal guilty pleas and personal bankruptcies, as required). Moreover, FINRA allows brokers to routinely scrub customer complaints from their public records when they settle arbitration claims. As a result, investors using FINRA's BrokerCheck are led to believe that a broker has a clean disciplinary record, when that is not true. See Jean Eaglesham & Rob Barry, *Stockbroker Requests to Scrub Complaints Are Often Granted*, WALL ST. J. (Oct. 16,

provision includes a reasonable care exception because it is nearly impossible for issuers and their underwriters to ascertain whether anyone involved with an offering engaged in potentially disqualifiable activity.¹⁴²

Disqualifications can be an effective prophylactic measure to reduce the risk of fraud in securities offerings, provided that the Commission understands what factors increase the risk of fraud, and that it effectively enforces disqualifications.

B. Sanction Enhancement

The second plausible rationale for disqualification provisions is that they increase the total sanction against the securities defendant. The original bad-actor disqualification was based on the idea that a sanctioned firm or individual was “unworthy.”¹⁴³ More recently, U.S. Senator Sherrod Brown has advocated using disqualifications as sanction enhancements, asserting that disqualifications “will promote better behavior, increase accountability, and demonstrate to the financial markets that certain firms do not enjoy special treatment by virtue of their size.”¹⁴⁴ Where misconduct involves officers or directors of the company, persists for years, and is otherwise egregious, the SEC’s Division of Corporation Finance has suggested that a disqualification may be necessary to adequately sanction the offender and to deter future misconduct.¹⁴⁵ Conversely, the Division has indicated a willingness to grant waivers from automatic disqualifications where the impact on the defendant firm would be disproportionate to the misconduct.¹⁴⁶

But automatic disqualifications are blunt tools. In a first-best world firms are assessed an appropriately large financial penalty.¹⁴⁷ Moreover, firms are required to disclose prior enforcement actions to their counterparties and to cooperate during prosecution. This would help sanction individual wrongdoers

2013), <http://www.wsj.com/articles/SB10001424052702303680404579139520100083360> (reporting that arbitrators grant more than 90 percent of requests to keep customer complaints off brokers’ records in settled cases).

142. See Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings, 78 Fed. Reg. at 44746.

143. HICKS, *supra* note 45, § 6:10.

144. Andrew Ackerman, *Sen. Brown to SEC: Stop Giving Banks a Pass on Wrongdoing*, WALL ST. J. (June 13, 2014), <http://blogs.wsj.com/moneybeat/2014/06/13/sen-brown-to-sec-stop-giving-banks-a-pass-on-wrongdoing> (quoting from a letter that U.S. Senator Sherrod Brown sent to SEC Chair Mary Jo White).

145. See Div. of Corp. Fin., Revised Statement, *supra* note 69. *But see* Gallagher, *supra* note 16 (finding the “punishment-focused view” of automatic disqualifications troubling).

146. *Waivers of Disqualification Under Rules 505 and 506 of Regulation D*, *supra* note 69.

147. See Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687 (1997) (explaining that the fine should be adjusted to incentivize self-reporting); Stephenson & Wagoner, *supra* note 18, at 802 (“Fines provide an ineffective mechanism for deterring white collar crime committed by corporations”); Urska Velikonja, *Leverage, Sanctions, and Deterrence of Accounting Fraud*, 44 U.C. DAVIS L. REV. 1281, 1285–88 (2011).

and produce fewer distortions. But in a second-best world, where maximum penalties are capped at relatively low levels,¹⁴⁸ and private enforcement is toothless,¹⁴⁹ the threat of an additional penalty in the form of a disqualification may be necessary to adequately deter lucrative misconduct that often avoids detection.¹⁵⁰

Underdeterrence in securities enforcement is not merely an academic concern. The true prevalence of securities violations is unknown. But many securities violations are low-visibility, high-return propositions, and likely considerably more common than enforcement actions would indicate.¹⁵¹ Several recent studies have tried to estimate the rates of misconduct and the likelihood of detection. Although the studies must make some significant assumptions about the unobserved rates of misconduct, their results nevertheless suggest that it is relatively easy for securities violators to avoid getting caught.

A study by Alexander Dyck, Adair Morse, and Luigi Zingales suggests that 14.5 percent of public companies are engaging in material and fraudulent earnings manipulation in any given year, and that their likelihood of getting caught is 27.5 percent.¹⁵² Another study by Jonathan Karpoff, D. Scott Lee, and Gerald Martin suggests that 22.9 percent of firms with foreign sales engaged in a multiyear program of prosecutable bribery at least once during a thirty-year period.¹⁵³ The study estimates the probability that a bribe-paying firm will face Foreign Corrupt Practices Act (“FCPA”) allegations at 6.4 percent. It concludes that for a vast majority of firms, paying bribes is a value-enhancing proposition. Even firms that were ultimately caught and paid large penalties to

148. The Justice Department fined BNP Paribas \$8.97 billion because that was the amount they could prove was criminal. Despite being the “largest-ever fine paid by a bank for violations of U.S. economic sanctions,” maximum sanctions are capped at twice that amount. See Devlin Barrett, Christopher M. Matthews & Andrew R. Johnson, *BNP Paribas Draws Record Fine for “Tour de Fraud,”* WALL ST. J. (June 30, 2014), <http://www.wsj.com/articles/bnp-agrees-to-pay-over-8-8-billion-to-settle-sanctions-probe-1404160117>. Civil fines that the SEC can impose are similarly limited. See 15 U.S.C. §§ 77t(d), 78u(d)(3) (2012); 17 C.F.R. § 201.1005 & tbl.V to subpart E (2015).

149. See Urska Velikonja, *Public Compensation for Private Harm: Evidence from the SEC’s Fair Fund Distributions*, 67 STAN. L. REV. 331, 368–74 (2015) (reporting that SEC enforcement is often the only enforcement action for securities fraud).

150. See Stein, *supra* note 13 (“These disqualification and bad actor provisions have the potential for deterrence at large institutions that no one-time financial penalty could ever wield.”).

151. In a recent study, Quinn Curtis and Minor Myers looked at the timing of stock-option grants, stock-price performance after the grant, and the likelihood of private or public enforcement. Their results suggest that many of the firms that were not targeted also likely backdated options. See Quinn Curtis & Minor Myers, *Do the Merits Matter? Evidence from Options Backdating Derivative Litigation*, 164 U. PA. L. REV. (forthcoming 2016) (manuscript at 38 fig.3).

152. See Alexander Dyck, Adair Morse & Luigi Zingales, *How Pervasive Is Corporate Fraud?* 25 (Rotman Sch. of Mgmt., Working Paper No. 2222608), <http://papers.ssrn.com/abstract=2222608>. They studied firms between 1996 and 2004, a period during which the prevalence of accounting manipulation was likely higher than historically. See *id.* at 6.

153. See Jonathan M. Karpoff et al., *The Economics of Foreign Bribery: Evidence from FCPA Enforcement Actions* (Mar. 21, 2014) (unpublished manuscript) (on file with author).

settle with the SEC or the Department of Justice paid so little that the firms benefited from bribery.¹⁵⁴ To eliminate the profits from paying bribes, “total penalties imposed on bribe payers would have to increase by 9.2 times,” assuming no change in the probability of getting caught, or the probability of getting caught would have to increase by 58.5 percent (to 64.9 percent), assuming constant penalties.¹⁵⁵ Finally, a study of residential mortgage-backed securities offerings suggests that misrepresentations of asset quality were “pervasive,” including among the “most reputable financial institutions.”¹⁵⁶ Underwriters misrepresented 6.4 percent of all non-owner-occupied mortgages as principal residence mortgages, and misreported second liens in 7.1 percent of all underwritten mortgages.¹⁵⁷ The misrepresentations were economically significant because nonowner and second-lien mortgages were far more likely to default.¹⁵⁸ The buyers of the packaged mortgage instruments—mutual funds, pension funds, and other institutional investors—consistently overpaid, yielding underwriters billions in excess revenues.¹⁵⁹ More robust internal risk management did not reduce the likelihood of misrepresentation.¹⁶⁰ The authors conclude that existing market arrangements, coupled with high-powered incentives that are common in financial institutions, have contributed to high rates of misconduct.¹⁶¹

The studies identify a clear pattern: relatively high rates of misconduct with moderate rates of detection, coupled with relatively small penalties. Since many of these crimes yield high returns for firms, sanctions would have to be increased considerably for optimal deterrence, which requires larger penalties when the risk of detection is lower. But under many securities provisions, sanctions against entities are capped at relatively low levels.¹⁶² And so, sanction enhancements in the form of disqualifications for the most serious offenses could be a second-best solution to ensure that fraud does not pay.

154. *See id.* at 3–4.

155. *Id.* at 5.

156. Tomasz Piskorski, Amit Seru & James Witkin, *Asset Quality Misrepresentation by Financial Intermediaries: Evidence from the RMBS Market* 31, 34 (Columbia Bus. Sch., Research Paper No. 13-7), <http://papers.ssrn.com/abstract=2215422>.

157. *See id.* at 29.

158. *See id.* at 19–25.

159. *See id.*

160. *See id.* at 34.

161. They suggest that firms are unlikely to eliminate misconduct without profound industry-wide changes. *See id.* at 31.

162. The most recent inflation adjustment authorizes the SEC to fine individuals up to \$160,000 and firms up to \$775,000 for each violation, or the “gross amount of pecuniary gain” from the violation, whichever is greater. 17 C.F.R. § 201.1005 & tbl. V to subpart E (2015). The language authorizing the fine up to the “gross amount of pecuniary gain” authorizes the SEC to impose a civil fine that equals the amount of disgorgement, doubling the total monetary sanction against the defendant, but not more. 15 U.S.C. §§ 77t(d), 78u(d)(3) (2012); 17 C.F.R. § 201.1005 & tbl. V to subpart E (2015).

Automatic disqualifications enhance sanctions in three ways: by increasing the total cost, by extending the duration of the sanction, and by condemning the defendant in ways a fine does not. First, and most obviously, a bad-actor or ineligible-issuer disqualification increases the cost of raising capital for a firm subject to a disqualification, and thus increases the total cost of the enforcement action to the firm.¹⁶³ A disqualification can add bite to the direct sanction where the maximum fine is too low. The Division of Corporation Finance suggests that the Commission consider the cost of the disqualification to the sanctioned entity and weigh it against the severity of the violation to decide whether a sanction enhancement is warranted.¹⁶⁴

A disqualification can also substitute for the monetary penalty where it is clear that the defendant cannot pay. For example, most defendants charged with Ponzi schemes and affinity frauds cannot pay the monetary penalties that the SEC imposes.¹⁶⁵ But they never receive waivers from disqualification provisions. Relatedly, it is not unusual for the SEC to force large financial firms to pay larger monetary penalties, but waive automatic disqualifications.¹⁶⁶ This pattern suggests the possibility that the Commission might be substituting automatic disqualifications for fines.¹⁶⁷

163. See, e.g., Letter from Craig A. Stewart, Arnold & Porter LLP, to Mary J. Kosterlitz, Chief, Office of Enf't Liaison, Div. of Corp. Fin., SEC, SEC v. GE Funding Capital Mkt. Servs., Inc., No. 2:11-cv-07465-WJM-MF (Jan. 17, 2012), in Gen. Elec. Capital Corp., SEC Exemptive Letter attachment at 3 (Jan. 24, 2012), <http://www.sec.gov/divisions/corpfin/cf-noaction/2012/gecapital012412-405.pdf> (explaining that the defendant and the SEC “carefully crafted” the terms of the settlement and that the disqualification would “impose an additional punishment beyond the agreed-upon settlement terms”); Letter from Stephanie Avakian, Wilmer Cutler Pickering Hale & Dorr LLP, to Mary J. Kosterlitz, Chief, Office of Enf't Liaison, Div. of Corp. Fin., SEC, *In re* Certain GIC Brokers, SEC File No. P-01118 (July 6, 2011), in JPMorgan Chase & Co., SEC Exemptive Letter attachment at 3 (July 11, 2011), <http://www.sec.gov/divisions/corpfin/cf-noaction/2011/jpmorgan071111-405.pdf> (same). See generally Jennifer Arlen, *Corporate Criminal Liability: Theory and Evidence*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CRIMINAL LAW 144, 150 (Alon Harel & Keith N. Hylton eds., 2012) (discussing collateral consequences among nonmonetary sanctions and concluding that they ought to be included in the expected government-imposed penalty).

164. *Waivers of Disqualification Under Rules 505 and 506 of Regulation D*, *supra* note 69 (“We will weigh the severity of the impact on the issuer if the waiver request is denied and weigh any such impact against the facts and circumstances relating to the violative or criminal conduct to assess whether the loss of WKSI status would be a disproportionate hardship in light of the nature of the issuer’s misconduct.”).

165. See, e.g., William E. Gibson, *Florida Victims Seek Compensation for Allen Stanford Ponzi Scheme*, SUN SENTINEL (Fort Lauderdale, Fla.) (Mar. 9, 2012), http://articles.sun-sentinel.com/2012-03-09/business/fl-ponzi-victims-get-relief-20120309_1_ponzi-scheme-florida-victims-stanford-international-bank (noting that the victims of Allan Stanford’s Ponzi scheme can expect to recover “less than 5 cents on the dollar” from restitution ordered by a Houston court in a criminal securities action).

166. Cf. Gadinis, *supra* note 19, at 709–11, 712 (reporting that large broker-dealer firms paid larger penalties than smaller firms, likely due to their greater financial resources, but received fewer and shorter industry bans).

167. The Division of Corporation Finance makes waiver determinations independent of the enforcement action. But when the Commission issues a waiver, that determination is invariably tied with the enforcement action. In at least one case, the defendant company conditioned its consent to

Finally, a disqualification is a qualitatively different type of “punishment” than a monetary penalty. It communicates disapproval of the defendant by excluding it from benefits others enjoy, and lets the defendant and the public know that some violations are worse than others. The expressive function of disqualifications can increase the deterrent punch of the penalty beyond the direct financial cost to the sanctioned entity.¹⁶⁸ For example, when BNP Paribas pled guilty to criminal charges for securities violations and agreed to pay a nearly \$9 billion fine, every news story about the settlement mentioned the bank’s suspension of its dollar-clearing ability, and most treated the suspension as a more significant part of the punishment than the fine.¹⁶⁹

But until mid-2014 when SEC Commissioners Aguilar, Gallagher, and Stein took an interest in waivers, the SEC did not have a practice of widely distributing the news that a particular defendant was disqualified as a result of its enforcement action or had received a waiver.¹⁷⁰ Disqualifications are not even mentioned in press releases celebrating large settlements. Except for well-advised defendants and their lawyers, no one apparently knew that a securities enforcement action triggers automatic disqualifications.

C. Arguments Against Automatic Disqualifications

Even if collateral consequences against firms can be effective at reducing recidivism or increasing punishment, or both, their use has been controversial. The first critique is that automatic disqualifications are overbroad.¹⁷¹ They are imposed automatically upon issuance of certain enforcement orders. A disqualification under Rule 506(d) will bar a company, its parent company (if there is one), and any entity in which the disqualified company owns 20 percent or more of the stock.¹⁷² As a result, disqualification of an investment management firm will also disqualify portfolio companies in which the

settling the enforcement action on receipt of a WKSJ waiver. See OIG BOFA REPORT, *supra* note 66, at 45–46.

168. See DAVID GARLAND, PUNISHMENT AND MODERN SOCIETY: A STUDY IN SOCIAL THEORY 252 (1990) (explaining that punishments “communicate[] meaning not just about crime and punishment but also about power, authority, legitimacy, normality, morality, personhood, social relations”); see also Dan M. Kahan, *The Secret Ambition of Deterrence*, 113 HARV. L. REV. 413, 419–21 (1999) (providing a normative account of the expressive theory of punishment).

169. See, e.g., Protess & Silver-Greenberg, *supra* note 21.

170. In fact, only waivers issued as no-action letters appear on the SEC’s website. See *Division of Corporation Finance No-Action, Interpretive and Exemptive Letters*, SEC, <http://www.sec.gov/divisions/corpfin/cf-noaction.shtml> (last visited Aug. 16, 2015). The only way to determine that a firm has been disqualified is by the absence of a waiver when the enforcement action triggered a disqualification. See Mary Jo White, Chair, SEC, *Understanding Disqualifications, Exemptions and Waivers Under the Federal Securities Laws*, Remarks at the Corporate Counsel Institute (Mar. 12, 2015), <http://www.sec.gov/news/speech/031215-spch-cmjw.html> (noting that Chair White had to request that SEC staff keep track of waiver denials).

171. See Gallagher, *supra* note 16. The critique applies to collateral consequences generally, not only when imposed against entities. See also Grant et al., *supra* note 25, at 1155–59.

172. See 17 C.F.R. § 230.506(d) (2015).

investment funds own minority stakes.¹⁷³ In some cases, misconduct by a small subsidiary in which the parent holds a minor stake should not raise red flags for recidivism by the parent. In other cases, the cost of disqualification to the defendant firm would be high relative to the severity of the offense.¹⁷⁴

The second, and more serious critique of using disqualifications against firms is that disqualifications harm third parties that were not involved in the violation, including employees and customers. But all sanctions, direct and collateral, produce third-party effects. The whole family suffers when the breadwinner is convicted of insider trading.¹⁷⁵ An audit firm can dissolve when faced with a large civil settlement, leaving thousands jobless.¹⁷⁶ Collateral consequences are not fundamentally different from direct sanctions. The only real difference is that their ultimate cost may be difficult to ascertain *ex ante*.¹⁷⁷

The uncertainty of the cost may explain why the SEC does not appear to consider externalities associated with monetary sanctions, but does consider third-party effects of automatic disqualifications “for the markets as a whole and the investing public” when deciding whether a waiver of a disqualification is appropriate.¹⁷⁸ Still, while the SEC considers third-party effects, there is no evidence that third-party effects have been the primary reason for any waiver. Indeed, waiver justifications offered by defendant firms are generally limited to consequences for their own operations, not those of third parties.¹⁷⁹ Only a handful of waiver requests even mention third-party effects. For example, Jefferies, a brokerage firm fined by the SEC for defrauding the federal Troubled Asset Relief Program,¹⁸⁰ suggested that its disqualification would have “an adverse effect on third parties that have retained, or may retain” Jefferies in the future.¹⁸¹ What Jefferies is describing is not a third-party effect but rather a direct cost to Jefferies from losing future business.

173. See, e.g., *In re Certain Current Funds, Third Party Issuers & Portfolio Cos. affiliated with Credit Suisse AG*, Securities Act Release No. 9589 (May 19, 2014), <http://www.sec.gov/rules/other/2014/33-9589.pdf>.

174. See, e.g., Oppenheimer Waiver Request, *supra* note 75, at 8 (arguing that a disqualification would jeopardize the firm’s alternative investment, private client, and investment banking businesses).

175. See, e.g., Matthew Goldstein, *Former Trader at SAC Capital Seeks Lenient Sentence for Insider Trading*, N.Y. TIMES, May 29, 2014, at B10 (citing from letters submitted before the sentencing hearing that a long sentence would leave the defendant’s stay-at-home wife and three young children without financial support).

176. See Frederic M. Stiner, Jr., *Bankruptcy of an Accounting Firm: Causes and Consequences of the Laventhol & Horwath Failure*, 3 ECON. & BUS. J. 1, 1–2 (2010) (describing the failure of the seventh-largest accounting firm in the United States as a result of two costly civil settlements).

177. See Coffee, *supra* note 114, at 401 (noting that the costs of financial penalties against corporations “tend to spill over onto parties who cannot be characterized as culpable”). See generally Urška Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887 (2013).

178. See Div. of Corp. Fin., Revised Statement, *supra* note 69.

179. See, e.g., Oppenheimer Waiver Request, *supra* note 75, at 6–8.

180. See *In re Jefferies LLC*, Exchange Act Release No. 71695 (Mar. 12, 2014), <https://www.sec.gov/litigation/admin/2014/34-71695.pdf>.

181. Letter from Paul R. Eckert, Wilmer Cutler Pickering Hale & Dorr LLP, to Sebastian Gomez Abero, Chief, Office of Small Bus. Policy, Div. of Corp. Fin., SEC, *In the Matter of Jefferies*

Other disqualifications, such as the revocation of a firm's investment adviser or broker registration could have larger third-party effects, but these can easily be overstated. For example, BNP Paribas received a waiver from an automatic disqualification as an investment advisor because a disqualification would be a "death sentence to a fund manager with implications for the fund investors."¹⁸² The disqualification would no doubt have been significant for BNP Paribas. But the only consequence to mutual fund investors would have been that another investment advisory firm, such as Vanguard or Fidelity, would have had to manage those funds, without any obvious additional costs to fund investors. The disqualification would have affected employees of the disqualified investment advisor, but whoever had taken over the fund could have rehired them, or BNP Paribas could have been directed to provide accommodations elsewhere. Where a disqualification is necessary to protect investors, a limited, delayed, or conditional waiver could considerably mitigate third-party losses.

III.

DATA, METHODOLOGY, AND OVERVIEW

This Part and Part IV report the results of a review of the SEC's disqualification and waiver practices. This Part explains the source of the data and discusses their many limitations. It then briefly explains the methodology employed and discusses summary findings.

A. The Data and Their Limitations

Bad-actor and ineligible-issuer disqualifications automatically accompany certain criminal and serious civil securities-enforcement actions.¹⁸³ The Commission does not keep track of disqualified firms and individuals, and in this study, I did not try to determine how many firms have been disqualified under each provision. Based on findings in the SEC's analysis of triggering events under Rule 506(d) and an analysis of the SEC's annual reports, this study estimates that about 40 to 45 percent of SEC enforcement actions trigger one or more bad-actor and ineligible-issuer disqualifications. These disqualifications affect roughly 30 percent of defendants in enforcement actions.¹⁸⁴ The number of defendants that the SEC charged during the study

LLC; File No. 3-15785, Jefferies LLC, SEC Exemptive Letter attachment at 4 (Mar. 12, 2014), <http://www.sec.gov/divisions/corpfin/cf-noaction/2014/jefferiesllc-3b-506d-031814.pdf>.

182. See Sarah N. Lynch, *Exclusive: SEC Official Dissented on BNP Paribas Waiver*, REUTERS (July 2, 2014), <http://www.reuters.com/article/2014/07/02/us-bnp-paribas-waiver-exclusive-idUSKBN0F72DO20140702> (quoting Robert Plaze, former SEC deputy director of the Division of Investment Management).

183. See discussion *supra* Part I.B.

184. The SEC analyzed enforcement actions between 2007 and 2011 and identified 1,485 enforcement actions against 2,578 individuals and entities that would have triggered a disqualification under Rule 506(d). See *Disqualification of Felons and Other "Bad Actors" From Rule 506 Offerings*,

period, between 2003 and 2014, has ranged from 1,163¹⁸⁵ to 1,861,¹⁸⁶ averaging 1,560 per year. This implies that in any given year, somewhere between 350 and 550 individual and entity defendants would be disqualified under Rule 506(d).¹⁸⁷

A defendant can request a waiver from disqualification by showing good cause. Individuals almost never receive a waiver. Firms receive waivers somewhat more frequently, but still not often. A very rough back-of-the-envelope calculation suggests that about 10 percent of disqualified firms receive a waiver from a disqualification.¹⁸⁸ This observation contradicts the conventional wisdom that waivers are “numerous”¹⁸⁹ and routine, and “the rule rather than the exception.”¹⁹⁰

This back-of-the-envelope estimate does not imply that 90 percent of waiver requests by firms are routinely denied. Data on waiver requests is

78 Fed. Reg. 44730, 44760 (July 24, 2013) (codified at 17 C.F.R. pts. 200, 230, 239 (2015)). The aggregate number of enforcement actions brought between 2007 and 2011 was 3,407, and the aggregate number of individuals and entities targeted in enforcement actions during that period was 8,549. *Id.* Not all of the enforcement actions brought in those years were resolved during that period, and some brought before 2007 settled during the SEC’s study period, so the numbers in the SEC Performance and Accountability Reports in the final rule justification are not perfectly comparable. A rough estimate comparing the numbers in both sets of documents suggests that about 43.5 percent of enforcement actions would trigger a disqualification from Rule 506(d), and disqualify about 30 percent of all defendants.

The list of triggering events under Regulation A and Rule 505 is somewhat shorter than the list in Rule 506(d), so one would expect relatively fewer firms to be disqualified. Although arguably more offenses render an issuer ineligible for WKSI status and free writing prospectus rules, fewer firms overall are charged under disqualifying provisions and fewer qualify for WKSI status.

185. SEC, SELECT SEC AND MARKET DATA FISCAL 2006, at 3 (2006), <https://www.sec.gov/about/secstats2006.pdf>.

186. *Id.*

187. Although triggering events vary between the bad-actor and ineligible-issuer disqualification provisions, the differences are small. Moreover, in 75 percent of cases, the triggering event was an injunction or a cease-and-desist order that enjoined the person from violating securities laws related to the offer or sale of securities, a false filing with the Commission, or misconduct by the underwriter, broker, dealer, investment adviser, or paid solicitor. *See* Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings, 78 Fed. Reg. at 44760. The injunction provision in Rules 262, 405, 505, and 506(d) is quite similar. *See* 17 C.F.R. §§ 230.262(a)(4), .405 (paragraph (1)(vi) of the definition of “ineligible issuer”), .505(b)(2)(iii), .506(d)(ii) (2014).

188. The SEC’s review of enforcement actions concluded in FY 2007–11 reports that of 2,578 disqualified persons, between 70 and 78 percent of triggering events were against individuals, implying that between 22 and 30 percent were against firms. *See* Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings, 78 Fed. Reg. at 44761. Taking the midpoint figure of 26 percent as an estimate of the average during the study period implies that about 670 firms were disqualified in FY 2007–11. In my review of granted waivers I found that the SEC granted at least one waiver to sixty-three firms and subsidiary groups that settled enforcement actions in FY 2007–11. There are relatively small differences between the events that trigger a disqualification under various rules, *see supra* note 187, small enough that the back-of-the-envelope estimate has some estimation value.

189. JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 303 (7th ed. 2013).

190. Ackerman, *supra* note 144 (quoting Senator Sherrod Brown).

unavailable,¹⁹¹ but interviews with counsel representing defendant firms and Commission staff suggest that not all disqualified defendants request a waiver,¹⁹² and that some request a waiver from only one disqualification provision, even where the enforcement action triggers multiple disqualifications. The reasons vary. In some cases, defendants and their counsel are not aware that the resolution of an enforcement action triggers a disqualification. In others, it is obvious that a waiver request will be denied.¹⁹³ And in yet others, the defendant is not concerned about a disqualification because it does not plan to raise external capital under the disqualified provision.¹⁹⁴

At the same time, at least some waiver requests are denied. In a recent address, Chair White explained that in 2014, the Commission denied fourteen of twenty-seven waiver requests from Rule 506(d) disqualification and four of eleven waiver requests from the ineligible-issuer disqualification.¹⁹⁵ A review of individual cases suggests a similar pattern. For example, when Dell settled an enforcement action for accounting fraud in October 2010, it was a WKSJ. The settlement triggered old bad-actor and ineligible-issuer disqualifications.

191. I submitted a FOIA request for requested waivers under Rules 262, 505, 506, and 405. I was informed that the Commission did not collect information about requested waivers but only about granted waivers, and I was directed to its website where it collects no-action letters. *See supra* note 20.

192. In a comment letter responding to the proposed rule on the Rule 506(d) disqualification provision, Disqualification of Felons and Other “Bad Actors” From Rule 506 Offerings, 76 Fed. Reg. 31518 (proposed June 1, 2011) (codified as amended at 17 C.F.R. pts. 200, 230, 239 (2015)), several law firms expressed concern that disqualifications would serve as a “trap for the unwary.” Wilmer Cutler Pickering Hale & Dorr LLP; Cravath, Swaine & Moore LLP; Davis Polk & Wardwell LLP; Gibson, Dunn & Crutcher LLP; and Skadden, Arps, Slate, Meagher & Flom LLP Comment Letter on Proposed Rule on Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings 3, 13 (July 14, 2011), <http://www.sec.gov/comments/s7-21-11/s72111-28.pdf>.

193. Nearly all granted waivers include a recommendation by the enforcement staff, so it seems likely that without a recommendation, the Division of Corporation Finance does not issue a waiver. *See, e.g.*, Letter from Paul R. Eckert, Wilmer Cutler Pickering Hale & Dorr LLP, to Mauri Osherooff, Assoc. Dir., Div. of Corp. Fin., SEC, SEC v. RBS Sec. Inc., Civ. Action No. 3:13-cv-01643-WWE (D. Conn. Nov. 25, 2013), *in* RBS Sec. Inc., SEC Exemptive Letter attachment at 1 (Nov. 25, 2013), [http://www.sec.gov/divisions/corpfin/cf-noaction/2013/rbssecurities-section3\(b\)-112513.pdf](http://www.sec.gov/divisions/corpfin/cf-noaction/2013/rbssecurities-section3(b)-112513.pdf) (“The staff of the Division of Enforcement has informed RBS Securities that it does not object to the Commission providing the requested waivers.”); Letter from Herbert F. Janick III, Bingham McCutchen LLP, to Gerald J. Laporte, Chief, Office of Small Bus. Policy, Div. of Corp. Fin., SEC, SEC v. J.P. Morgan Sec. LLC, Civ. Action No. 11-CV-4206 (S.D.N.Y. June 21, 2011), *in* J.P. Morgan Sec. LLC, SEC Exemptive Letter attachment at 1 (June 29, 2011), <http://www.sec.gov/divisions/corpfin/cf-noaction/2011/jpmorgansecurities062911-505.pdf> (“It is our understanding that the Division of Enforcement supports our request for such a determination.”). Due to lack of transparency at the SEC, we cannot say anything useful about whether the Division of Corporation Finance denies waivers when enforcement staff recommends it.

194. For example, nonfinancial firms might not request certain waivers because the cost of the disqualification is relatively low. For them, the only consequence of a disqualification is that they cannot raise capital under disqualified provisions. But they can still get a loan, conduct a Section 4(a)(2) or Rule 144A offering or a sale to foreign investors under Regulation S, or use cash flow that they generate to fund new investment.

195. *See* White, *supra* note 170.

Dell received a waiver from the old bad-actor disqualification provisions and remained eligible to raise capital under Regulation A and Rule 505 of Regulation D, but it did not receive a waiver from the ineligible-issuer disqualification under Rule 405.¹⁹⁶ During the five-year period before the settlement, Dell did not rely on Regulations A and D to raise capital, but did file an automatic shelf-registration statement.¹⁹⁷ It is very likely that Dell requested both waivers, but was denied the WKSI waiver.

Because information on requested waivers is not available, we do not know the denominator (the number of requested waivers) to determine how often waivers are granted and whether there is variability in granted waivers depending on the nature of the offense, the size and the industry of the defendant entity, or the size of the penalty, etc. The study thus cannot say whether, as Commissioner Stein suggested, certain firms are systematically and unfairly more likely than other similarly situated firms to receive waivers from disqualifications.¹⁹⁸

Comparing the number and the type of issued waivers to the number and the categories of enforcement actions is nonetheless useful to reach some general (albeit contingent) conclusions about the SEC's disqualification and waiver practices, and their significance for issuers and other securities market participants. To reach the conclusions reported in this Part and Part IV, I collected all no-action letters waiving bad-actor and ineligible-issuer disqualifications between July 2003 and December 2014.¹⁹⁹ I collected information on the type of waiver (bad-actor disqualification under Rule 505, 262, or 506(d); or ineligible-issuer disqualification under Rule 405); the date of issue of the order imposing sanctions and of the waiver; the nature of the securities violation involved using the SEC's classification published in the *Select SEC and Market Data* reports for the relevant period;²⁰⁰ information about the size of the civil fine and disgorgement; information about the

196. See Dell Inc., SEC Exemptive Letter (Oct. 13, 2010), <http://www.sec.gov/divisions/corpfin/cf-noaction/2010/dell101310.pdf>. Dell is not alone among defendants that received only one waiver when multiple disqualifications were triggered. See, e.g., Am. Int'l Grp., Inc., SEC Exemptive Letter (Feb. 21, 2006), <http://www.sec.gov/divisions/corpfin/cf-noaction/aig022106.pdf>.

197. Dell Inc., Registration Statement Under the Securities Act of 1933, at 2 (Form S-3) (Nov. 4, 2008) ("This prospectus is part of an automatic shelf registration statement that we have filed with the Securities and Exchange Commission, or SEC, as a 'well-known seasoned issuer' as defined in Rule 405 under the Securities Act of 1933.").

198. See Stein, *supra* note 13.

199. Old bad-actor waivers are available from 2003 to present day. The study reviewed WKSI waivers from December 1, 2005, to December 31, 2014, and new bad-actor waivers from September 23, 2013, to December 31, 2014, when each disqualification provision became effective. No-action letters are listed on the SEC's website. See *Division of Corporation Finance: No-Action, Interpretive and Exemptive Letters*, DIV. OF CORP. FIN., SEC (June 18, 2015), <http://www.sec.gov/divisions/corpfin/cf-noaction.shtml>.

200. *About the SEC*, SEC (May 27, 2015), <http://www.sec.gov/about.shtml> (listing reports from 2004 until 2014).

recipient of the waiver (i.e., individual or entity, financial or nonfinancial firm); and the number of employees. The following Sections report summary results.

B. General Characteristics of Granted Waivers

The data set includes 201 no-action letters issued to 162 defendants or defendant groups²⁰¹ in 145 enforcement actions concluded between July 2003 and December 2014.²⁰² Only two individual defendants received waivers;²⁰³ firms received all other waivers. Many waiver recipients were large financial institutions and their subsidiaries, mostly household names that include J.P. Morgan Chase, Goldman Sachs, Bank of America, Prudential, UBS, and Citigroup.²⁰⁴ Large financial firms received 164 of 201 granted waivers (81.6 percent). Sixteen waivers were issued to smaller financial firms, and twenty-one waivers were issued to nonfinancial companies (including insurance firms).

More than two-thirds of all waivers, 138 of 201 (68.7 percent), triggered by 111 of 162 enforcement actions (68.5 percent) in which a waiver was issued, were issued to firms that received waivers related to more than one enforcement action during the study period. All but four are large financial firms. The true share of waivers issued to repeat offenders is probably higher because even large financial firms sometimes do not receive a waiver²⁰⁵ and because many violations of securities laws do not trigger a disqualification.²⁰⁶

201. An enforcement action against a subsidiary will trigger disqualification for the entire group, including the parent and other affiliated entities. For example, the settlement and \$10 million fine against Sand Canyon Corporation for misleading investors who bought residential mortgage-backed securities triggered the ineligible-issuer disqualification for the parent company, H&R Block, which is a WKSI, as well as the bad-actor disqualification for the parent and all affiliated entities. The sanctioned subsidiary ceased operations in 2008 and settled the enforcement action that triggered the disqualification in 2012. The SEC waived the ineligible-issuer disqualification for H&R Block, and the bad-actor disqualification for both H&R Block and its financial subsidiary, Block Financial LLC, the direct parent of the sanctioned entity. See H&R Block, Inc., SEC Exemptive Letter (May 3, 2012), <http://www.sec.gov/divisions/corpfin/cf-noaction/2012/hrblock050312-405.pdf>; H&R Block, Inc., SEC Exemptive Letter (May 2, 2012), <http://www.sec.gov/divisions/corpfin/cf-noaction/2012/hrblock050212-505.pdf>.

202. Several enforcement actions involved multiple different defendants and defendant groups.

203. Both received waivers from the old bad-actor disqualifications. See Pritchard Capital Partners, LLC, SEC Exemptive Letter (Apr. 23, 2008), <http://www.sec.gov/divisions/corpfin/cf-noaction/2008/pritchard042308.pdf>; Dunham & Assoc. Investment Counsel, Inc., SEC Exemptive Letter (Sept. 22, 2006), <http://www.sec.gov/divisions/corpfin/cf-noaction/daic092206-sec3b.pdf>.

204. The study classifies as large firms those that had more than one thousand employees at the group level during the year in which the action was finalized and as small those that had fewer. Gadinis, *supra* note 19, at 693 & n.70 (“Distinctions between big and small firms are common in the literature.”).

205. For example, Citigroup settled an enforcement action involving an issuer reporting and disclosure violation, which triggered an ineligible-issuer disqualification. Citigroup did not receive a waiver and was disqualified from using its WKSI status for three years. See Ackerman, *supra* note 110.

206. See, e.g., OIG BOFA REPORT, *supra* note 66, at 56 (explaining that Bank of America “neither needed nor received the waiver because an antifraud injunction was never entered”).

TABLE 1.
SUMMARY INFORMATION ON THE SEC'S BAD-ACTOR AND INELIGIBLE-ISSUER
WAIVERS (2003–2014)²⁰⁷

		Financial (Large)	Financial (Small)	Nonfinancial*	Total
Count and Percentage of Waivers by Company Type (Listed by Count and Percentage of That Type of Waiver)	505	91 82.7%	12 10.9%	7 6.4%	110
	WKSI	64 80.0%	3 3.7%	13 16.3%	80
	506(d)	9 81.8%	1 9.1%	1 9.1%	11
	Total Waivers by Company Type	164 81.6%	16 8.0%	21 10.4%	201
Count and Percentage of Multiple Waivers (N=162)	More Than One Waiver in a Single Enforcement Action	33 25.6%	2 14.3%	2 10.5%	37 22.8%
	Exactly One Waiver in an Enforcement Action	96 74.4%	12 85.7%	17 89.5%	125 77.2%
	More Than One Enforcement Action Resulting in Waivers	107 82.9%	2 14.3%	2 10.5%	111 68.5%
	Exactly One Enforcement Action Resulting in Waivers	22 17.1%	12 85.7%	17 89.5%	51 31.5%
Total Sanction (in 2014 dollars)	Mean (in '000)	\$64,259	\$70,968	\$99,513	\$63,812
	Median (in '000)	\$8,433	\$23,631	\$15,000	\$10,688

* The count includes two waivers from Rule 505 automatic disqualification issued to individual defendants.

Analyzing the size of the monetary penalties associated with waivers relative to all enforcement actions is suggestive of when a waiver is more likely. Enforcement actions that resulted in waivers were relatively large, with a mean settlement of \$63.8 million (the median settlement was \$10.7 million).²⁰⁸ By comparison, during the fiscal year 2011, the mean monetary penalty in all SEC settlements with firms was \$7.8 million (the median settlement was \$1.6 million).²⁰⁹

The size of monetary penalties associated with waivers could be read to suggest that the alleged misconduct of firms that received a waiver was more

207. For underlying data, see *Division of Corporation Finance: No-Action, Interpretive and Exemptive Letters*, *supra* note 199.

208. In 2014 dollars.

209. Both figures are reported in 2014 dollars. See ELAINE BUCKBERG ET AL., NERA ECON. CONSULTING, SEC SETTLEMENT TRENDS: 2H11 UPDATE 25 (2012). The overall mean and median were \$4.30 million and \$332,136, respectively. Average and median settlements with individual defendants are smaller, \$2.09 million and \$175,000, respectively. See *id.*

serious than by those that did not. However, there are two more plausible explanations. First, waiver recipients are overwhelmingly large companies, and monetary penalties tend to correlate with the size of the respondent and its ability to pay.²¹⁰ Second, the large size of monetary penalties associated with waivers could suggest that the SEC is willing to grant a waiver in exchange for extracting a larger fine from defendants.²¹¹ A bad-actor or ineligible-issuer disqualification can increase the cost of raising capital or bar the disqualified firm from offering financial products and services to its client, thus operating as an additional sanction for the misconduct. One way to read this information is that the SEC grants waivers in exchange for a larger fine, at least in cases that do not involve serious accounting manipulation or fraudulent securities offerings.²¹² Data limitations make it impossible to analyze this hypothesis in any depth, beyond anecdotes.²¹³

Waivers are granted only in cases that are settled, not in those that are adjudicated. Firms that receive waivers receive them promptly, to ensure there is no disruption in their capital-raising activities. A large majority of waivers, 71.1 percent, are issued on the date of the final settlement of the enforcement action that triggers the automatic disqualification.²¹⁴ Median and modal delay for granted waivers is thus zero. Where the waiver is not issued on the same day that the settlement is finalized, average delay is fifty-four days. The average is upwardly biased by a handful of cases with delays in excess of one hundred days. The median delay for cases with nonzero delay is nine days; the modal waiver delay is one day. This suggests a high degree of coordination between the Divisions of Enforcement and Corporation Finance, and the SEC's awareness of its pivotal role in the functioning of U.S. capital markets. Contrary to perceptions about government bureaucracies as ignorant, inefficient, and inept, the SEC's waiver practices suggest a hyperawareness of the cost of delay to defendant firms requesting waivers.²¹⁵

210. See Gadinis, *supra* note 19, at 712 (reporting higher fines against large broker-dealer firms and concluding that they reflect “their larger financial resources”).

211. The SEC has never said as much. But there is some weak evidence suggesting that disqualifications and monetary penalties are viewed as substitutes. *Cf.* Michaels & Schmidt, *supra* note 4 (reporting that one Commissioner was “re-evaluating whether he can vote to approve settlements without knowing the status of waivers”).

212. Accounting-fraud cases and Ponzi schemes are underrepresented in the population of waiver recipients relative to enforcement actions. See discussion *infra* Part IV.A.

213. Too few similarly situated public firms have lost WKSJ status to conduct a valid regression analysis.

214. The Division of Corporation Finance provides a process for requesting a waiver before the Commission's order approving the settlement or the final judgment becomes effective. See *Process for Requesting Waivers*, *supra* note 58 (“[I]f you are negotiating a settlement of a Commission enforcement action and want your waiver to be effective at the same time as the injunction or administrative order settling the matter is issued, you should contact Commission staff by e-mail or telephone as soon as practicable beforehand to discuss your timing requirements . . .”).

215. Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings, 78 Fed. Reg. 44730, 44748 (July 24, 2013) (codified at 17 C.F.R. pts. 200, 230, 239 (2015)) (“We are sensitive to

IV.

ANALYSIS OF THE SEC'S WAIVER PRACTICES

This Part offers an analysis of how the SEC has exercised its waiver discretion. First, the information on granted waivers suggests that the SEC has rarely, if at all, used disqualifications to enhance sanctions. Section IV.A reports evidence that the SEC grants waivers where it perceives the risk of recidivism to be low. For example, the data reveal that the SEC rarely grants a WKSI waiver to a firm charged with accounting fraud. At the same time, it is not obvious that the SEC has correctly identified the types of offenses that are red flags for future misconduct.²¹⁶ This Part proposes at least two additional categories that signal higher risk for recidivism: (1) WKSI disqualification where the defendant subsidiary was charged with securities offering fraud in reliance on the parent company's WKSI status, and (2) bad-actor and WKSI disqualification where the defendant firm's history of various seemingly unrelated securities violations suggests a larger problem with legal compliance. Second, this Part takes a closer look at Commissioner Stein's observation that large firms are systematically more likely than small- and medium-sized firms to receive waivers from automatic disqualifications, and her suggestion that such disparity is unfair.²¹⁷ And third, the number of granted waivers has declined over time, reflecting a change in the SEC's approach to disqualifications and waivers going back to at least 2010. Additionally, during the last year, the Commission has granted a handful of limited and conditional waivers, likely foreshadowing its future direction.

A. When Are Waivers Granted, and Why?

Part II of this Article offers two possible justifications for disqualifications: to reduce the risk of recidivism and to enhance the sanction where other penalties do not deter. The Commission has not clearly articulated principled reasons for disqualifications or waivers. It recently offered a laundry list of good causes for granting a waiver—a list that includes factors related to the risk of recidivism and concerns about the appropriate size of penalty.²¹⁸ The process for granting or denying waivers from disqualifications remains opaque.

However, an analysis of waivers granted under each disqualification provision—old bad-actor, ineligible-issuer, and the new bad-actor

concerns about delay in the waiver process, and believe that the staff has managed the process of granting waivers from Regulation A and Rule 505 disqualification appropriately in the past.”).

216. See discussion *supra* notes 133–37 and accompanying text.

217. See Stein, *supra* note 13. Only certain types of violations trigger automatic disqualifications. Because the SEC enforcement staff has discretion on what violations to charge, it is possible that the charging process is biased in favor of large financial firms.

218. *Waivers of Disqualification Under Rules 505 and 506 of Regulation D*, *supra* note 69. Concededly, a list of this sort is necessarily somewhat vague. But since the Commission possesses nearly complete discretion to grant waivers and the list is merely guidance, it could provide (1) more specific examples and (2) clear rules that it follows.

disqualification provision in Rule 506(d)—suggests that the Division of Corporation Finance has developed clear principles for granting or denying waivers, and has usually followed them closely. These principles suggest that the Division has historically understood disqualifications as mechanisms to reduce the risk of recidivism for fraud related to a primary offering of securities. At the same time, it is not obvious that the Division’s traditional criteria are the best predictors for future fraud.

1. Waivers by Nature of the Securities Violation

This Section discusses old bad-actor and ineligible-issuer disqualification provisions in the reverse order of their legal and economic significance. Most data is available for the old bad-actor disqualifications, followed by the ineligible-issuer disqualifications. Although triggering events for disqualifications and the specific threats that individual disqualifications are designed to eliminate differ, the lessons about how the SEC and its Division of Corporation Finance have exercised its waiver discretion applies to any individual disqualification provision.

Since July 2003, the Division of Corporation Finance has issued 110 waivers from Rule 262 and Rule 505 automatic-disqualification provisions. Two waivers were issued to individual defendants, and 108 to firm defendants. The Division issued sixty-six waivers (60 percent) in cases charging broker-dealer violations, many of which were trading violations,²¹⁹ and twenty (18.2 percent) in cases charging investment adviser violations, such as undisclosed fees and revenue sharing arrangements or market timing. The third and fourth largest categories are issuer reporting and disclosure violations, i.e., accounting fraud, and securities offering violations, in which the Division issued nine and eight waivers, respectively.

219. For example, Merrill Lynch settled an enforcement action, and received a waiver, when its traders traded ahead of institutional buyers based on tips they received from the order desk. *See In re Merrill Lynch, Pierce, Fenner, & Smith Incorporated*, Securities Act Release No. 9016 (Mar. 16, 2009), <https://www.sec.gov/rules/other/2009/33-9016.pdf>.

TABLE 2.
RULE 262 AND 505 WAIVERS BY NATURE OF VIOLATION (2003–2014)

	Number of Waivers (N=110)	Share of Waivers	Share of Defendants ²²⁰	Difference Between Waivers and Defendants
Broker-Dealer	66	60.0%	9.0%	51.0%
Investment Adviser ^a	20	18.2%	15.6%	2.6%
Issuer Reporting	9	8.2%	20.8%	(12.6%)
Securities Offering ^b	8	7.3%	32.2%	(24.9%)
Municipal Securities	3	2.7%	0.8%	1.9%
Market Manipulation	2	1.8%	10.8%	(9.0%)
Insider Trading	1	0.9%	10.3%	(9.4%)
FCPA	1	0.9%	0.5%	0.4%

^a Includes transfer agent violations.

^b Includes mortgage securities violations.

The second and third columns in Table 2 list by category of violation what share of granted waivers were granted in each category and what share of defendants were charged with each class of violation. The fourth column shows the difference between the share of granted waivers and the share of defendants in each category. A positive number suggests that the violation class is overrepresented among granted waivers, and a negative number, shown in parentheses, suggests that the category is underrepresented—that the Division issues fewer waivers than one would expect given the share of defendants.

The Division issues a lot more waivers in broker-dealer cases than would be expected if waiver grants were random,²²¹ and a lot fewer in securities offering and issuer-reporting cases. The results for WKSI waivers are similar, as reported in Table 3. Since December 2005 when the provision became effective, the Commission has issued eighty waivers from the automatic ineligible-issuer disqualification. As is true for old bad-actor disqualifications, waivers in cases against broker-dealers and investment advisers are overrepresented, while waivers in issuer reporting cases are underrepresented.²²² In other words, defendants charged with accounting fraud are less likely than defendants charged with broker-dealer violations to receive a waiver from the ineligible-issuer disqualification.

220. *About the SEC*, SEC (May 27, 2015), <http://www.sec.gov/about.shtml> (listing reports from 2003 to 2014). For more about the author's methodology, see Urska Velikonja, *Reporting Agency Performance: Behind the SEC's Enforcement Statistics*, 101 CORNELL L. REV. (forthcoming 2016).

221. The two-sided Chi-squared test is highly significant (P=0.0001). I did not control for the frequency of triggering events in each category of enforcement action, or for the different numbers of defendants present in each category. But I expect that the numbers would remain significant.

222. The two-sided Chi-squared test is highly significant (P=0.001).

TABLE 3.
WKSI WAIVERS BY TYPE OF ENFORCEMENT ACTION (2006–2014)

	Number of Waivers (N=80) (N=64) ^a	Share of WKSI Waivers ^b	Share of Defendants ²²³	Difference Between Waivers and Defendants
Broker-Dealer	22 <i>20</i>	28.2% <i>31.2%</i>	8.5%	19.7% <i>22.7%</i>
Investment Adviser	19 <i>13</i>	24.4% <i>20.3%</i>	16.4%	8.0% <i>3.9%</i>
Securities Offering ^c	16	20.5% <i>25.0%</i>	32.2%	(11.7%) <i>(7.2%)</i>
Issuer Reporting	11 <i>5</i>	14.1% <i>7.8%</i>	19.2%	(5.1%) <i>(11.4%)</i>
Municipal Securities	7	9.0% <i>10.9%</i>	1.0%	8.0% <i>9.9%</i>
Insider Trading	3	3.8% <i>4.7%</i>	10.7%	(6.9%) <i>(6.0%)</i>
Criminal	2	-	-	-
FCPA	0	0%	0.6%	(0.6%)
Market Manipulation	0	0%	11.4%	(11.4%)

^a Sixteen of eighty WKSI waivers were granted because the defendant reached the settlement before December 1, 2005, the day that the Securities Offering Reform regulation came into force, not because of any good cause determination.

^b The percentages do not include waivers in criminal cases because information on the number of defendants is not readily available.

^c Includes Securities Offering and Mortgage Securities.

Moreover, of eighty granted WKSI waivers, sixteen were granted because the defendant firm reached a provisional settlement with the SEC before December 1, 2005, when the ineligible-issuer provision became effective.²²⁴ If those waivers are excluded, the differences—reported in italics in Table 3—become larger and more significant: a lot fewer waivers are issued in issuer reporting, market manipulation, insider trading, and, to a lesser extent, securities offering cases.

223. *About the SEC*, *supra* note 220. For more about the author's methodology, see Velikonja, *supra* note 220.

224. *See* Securities Offering Reform, 70 Fed. Reg. 44722, 44747 (Aug. 3, 2005) (codified as amended at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 243, 249, 274) (providing that “ineligibility based on settlements will apply only to judicial or administrative decrees or orders entered into after the effective date of the new rules”).

2. *Are Waivers Granted When the Risk of Recidivism is Low?*

The Commission and Division of Corporation Finance have offered somewhat vague guidance on what justifies granting a waiver from an automatic disqualification. However, the Division's waiver practices discussed above suggest that the Division has developed fairly clear rules for waivers. The Division grants waivers when misconduct does not involve accounting violations, fraud in securities offering, insider trading, or market manipulation. This Section discusses the evidence and suggests that the Division reconsider what factors should be relevant in its assessment of recidivism risk.

a. Evidence of Disqualifications as Measures to Reduce Recidivism

Disqualifications make unavailable four offering types where the combination of speed, low disclosure, and minimal regulatory oversight leaves investors particularly vulnerable. As suggested in Part II.A, any prior securities enforcement action is a risk factor for future securities violations. But the SEC has not adopted a view that broad. Rather, its past pattern of waiver granting suggests that the Commission views some violations to be more risky than others.

According to the SEC, accounting fraud "calls into question the ability of the issuer to produce reliable disclosure currently and in the future."²²⁵ Data reported in Tables 2 and 3 offers some support for the claim that the Division is unwilling to grant waivers in issuer reporting cases. In addition, the Division has granted few bad-actor waivers in securities offering (many of which are Ponzi (and similar) schemes), insider trading, and market manipulation cases.²²⁶ By contrast, the SEC apparently believes that broker-dealer violations, such as misleading customers about intra-day trades²²⁷ or executing transactions for a customer despite red flags that the customer was overcharging its own clients,²²⁸ do not suggest higher likelihood for fraud in the offering of securities compared with uncharged firms.

The nature of the misconduct is only one factor affecting the likelihood of future securities fraud.²²⁹ Credible remedial steps can also reduce the likelihood of repeat misconduct, as does the existence of an alternative oversight regime,

225. See Div. of Corp. Fin., Revised Statement, *supra* note 69.

226. But, there are exceptions: the SEC sometimes waives automatic disqualifications where the large financial institution did file fraudulent disclosures with the SEC. See, e.g., *In re UBS Financial Services Inc.*, Securities Act Release No. 9318, Exchange Act Release No. 66893, 103 SEC Docket 1821 (May 1, 2012), <https://www.sec.gov/litigation/admin/2012/33-9318.pdf> (finding that the defendant made fraudulent disclosures to numerous customers regarding valuation and liquidity of its funds).

227. See, e.g., *Jefferies LLC*, *supra* note 181.

228. See *Instinet, LLC*, SEC Exemptive Letter (Dec. 26, 2013), <http://www.sec.gov/divisions/corpfin/cf-noaction/2013/instinet-122613-505.pdf>.

229. See discussion *supra* Part II.A.

such as the imposition of an external monitor,²³⁰ or closer SEC oversight. Many waiver requests list measures that firms have taken to prevent repeat misconduct.²³¹ For example, in 2005 the SEC issued a waiver from the old bad-actor disqualification to CIBC Mellon Trust Company, whose employees on behalf of a client issued restricted securities in an unregistered offering without complying with securities laws.²³² The firm's misconduct is precisely the sort of misconduct that the SEC asserts is correlated with the risk of future offering fraud. But CIBC Mellon Trust is a large financial firm that had "undertaken to engage an independent consultant"—a monitor—to review its procedures to presumably reduce the risk of recidivism.²³³ Moreover, CIBC Mellon Trust had resources that appeared to make its commitment to self-police credible.²³⁴ CIBC Mellon Trust also promised to register with the SEC as a transfer agent and subject itself to closer scrutiny.²³⁵

But even where a firm lists remedial measures that it has taken, not all measures are effective. The large share of repeat offenders in the census of waiver recipients could suggest that the SEC lets large financial firms off easy, despite the high risk of repeat misconduct. Moreover, the Division takes the firms' assertions about remedial steps at face value. For example, when the Division granted a waiver to CIBC Mellon Trust, it assumed, but did not verify, that its remedial steps would likely be effective.

b. Are Traditional Waiver Criteria Appropriate?

A close look at issuer and reporting cases reveals that the Commission considers a charge of accounting fraud and securities-offering violations to be

230. See, e.g., *In re Bank of Am.*, Securities Act Release No. 9682 (Nov. 25, 2014), <http://www.sec.gov/rules/other/2014/33-9682.pdf>.

231. See, e.g., Letter from Gail S. Ennis, Wilmer Cutler Pickering Hale & Dorr LLP, to Lona Nallengara, Deputy Dir., Div. of Corp. Fin., SEC, SEC v. J.P. Morgan Sec. LLC; EMC Mortgage, LLC; Bear Stearns Asset Backed Sec. I, LLC; Structured Asset Mortgage Invs. II, Inc.; SACO I, Inc.; and J.P. Morgan Acceptance Corp. I, Civ. Action No. 1:12-cv-01862 (D.D.C. Nov. 16, 2012), *in* JPMorgan Chase & Co., SEC Exemptive Letter attachment at 3–4 (Jan. 8, 2013), <http://www.sec.gov/divisions/corpfin/cf-noaction/2013/jpmorgan-chase-010813-405.pdf> (“The Defendants have taken steps to address the conduct alleged in the Complaint. . . . to prevent recurrence of the conduct alleged in the Complaint. Investors will be protected by these remedial activities taken by JPMC.”); Letter from Peter H. Bresnan, Simpson Thacher & Bartlett LLP, to Lona Nallengara, Deputy Dir., Div. of Corp. Fin., SEC, Credit Suisse HO-11546, *in* Credit Suisse AG, SEC Exemptive Letter attachment at 3 (Nov. 16, 2012), <http://www.sec.gov/divisions/corpfin/cf-noaction/2012/credit-suisse-ag-111612-405.pdf> (“The Settling Firms have taken steps to prevent conduct of the type alleged in the Order.”)

232. See CIBC Mellon Trust Company, SEC Exemptive Letter (Mar. 2, 2005), <http://www.sec.gov/divisions/corpfin/cf-noaction/cibc030205.pdf>.

233. Letter from Paul R. Eckert, Wilmer Cutler Pickering Hale & Dorr LLP, to Gerald J. Laporte, Chief, Office of Small Bus. Policy, Div. of Corp. Fin., SEC, *In the Matter of Pay Pop*, HO-7503 (Mar. 2, 2005), *in* SEC Exemptive Letter attachment at 3 (Mar. 2, 2005), <http://www.sec.gov/divisions/corpfin/cf-noaction/cibc030205.pdf>.

234. See CIBC Mellon Trust Co., *supra* note 229.

235. See *id.*

highly correlated with future risk of disclosure fraud. Between 2006 and 2011, over 150 companies were sanctioned for accounting fraud,²³⁶ yet during that period the SEC issued only nine bad-actor and ten ineligible-issuer waivers to affected firms (one was granted in 2013). Of eleven ineligible-issuer waivers that have been granted in accounting fraud cases since 2006, six were granted to clarify that the disqualification did not apply to settlements reached before December 1, 2005, when the ineligible-issuer disqualification became effective.²³⁷ Of the remaining five, two were issued to large firms that acquired disqualified entities that did not otherwise qualify for WKSI status;²³⁸ one to a firm sanctioned for backdating executive stock options, a violation that is widely perceived as less serious than earnings manipulation;²³⁹ and one to a firm that had cooperated with the SEC during the investigation, had taken extensive remedial steps, and was in poor financial health due to large penalties it paid to settle enforcement actions.²⁴⁰ IBM received a waiver after it helped another corporation, Dollar General, to manipulate its earnings, presumably because aiding and abetting another did little to increase the risk that IBM would manipulate its own earnings.²⁴¹

A review of individual waivers reveals two additional criteria for denying waiver requests that the Division should consider. The first observation is that the Division and the Commission have issued a relatively high number of WKSI waivers in securities offering cases. Twenty-five percent of substantive waivers—i.e., not including cases that settled before December 1, 2005—were issued in cases related to securities offerings; such cases represent 18.7 percent of enforcement actions and 29 percent of defendants. The relative share of waivers is smaller than the relative share of defendants, but higher than one

236. See BUCKBERG ET AL., *supra* note 208, at 16. Not all were WKSIs.

237. See Raytheon Co., SEC Exemptive Letter (Oct. 5, 2006), <http://www.sec.gov/divisions/corpfin/cf-noaction/raytheon100506.pdf>; MBIA Inc., SEC Exemptive Letter (Jan. 29, 2007), <http://www.sec.gov/divisions/corpfin/cf-noaction/2007/mbia012907-405.pdf>; Nicor, Inc., SEC Exemptive Letter (Mar. 29, 2007), <http://www.sec.gov/divisions/corpfin/cf-noaction/2007/nicor032907-405.pdf>; RenaissanceRe Holdings Ltd., SEC Exemptive Letter (Apr. 27, 2007), <http://www.sec.gov/divisions/corpfin/cf-noaction/2007/renaissancere042707-405.pdf>; Cardinal Health, Inc., SEC Exemptive Letter (Aug. 7, 2007), <http://www.sec.gov/divisions/corpfin/cf-noaction/2007/cardinalhealth080707-405.pdf>.

238. See O'Reilly Automotive, Inc., SEC Exemptive Letter (May 26, 2009), <http://www.sec.gov/divisions/corpfin/cf-noaction/2009/oreillyautomotive052609-405.pdf>; Hewlett Packard Co., SEC Exemptive Letter (July 20, 2007), <http://www.sec.gov/divisions/corpfin/cf-noaction/2007/hp072007-405.pdf>.

239. See Analog Devices, Inc., SEC Exemptive Letter (May 30, 2008), <http://www.sec.gov/divisions/corpfin/cf-noaction/2008/analogdevices053008-405.pdf>.

240. See Tenet Healthcare Corp., SEC Exemptive Letter (Apr. 19, 2007), <http://www.sec.gov/divisions/corpfin/cf-noaction/2007/tenet041907-405.pdf>. The waiver was controversial and many at the Division of Corporation Finance and the SEC believed that the waiver should not have been issued. See OIG BOFA REPORT, *supra* note 66, at 53 (reporting on the Division of Corporation Finance's displeasure with the Commission overruling its waiver decisions).

241. See Int'l Bus. Machs. Corp., SEC Exemptive Letter (June 26, 2007), <http://www.sec.gov/divisions/corpfin/cf-noaction/2007/ibm062607-405.pdf>.

would expect since the misconduct—offering fraud—is often closely related to WKSI disqualification. Several of the cases where firms received ineligible-issuer waivers involved false disclosures in offering documents and prospectuses for RMBS, CDO, and other mortgage securities,²⁴² one involved a Ponzi scheme. In sixteen securities-offering cases that resulted in a WKSI waiver, the SEC ordered firms to disgorge more than \$1.2 billion in profits. Disgorgement orders are based on the benefit from the violation that the SEC can prove, suggesting that these cases produce large losses to the victims. In several of these cases, the defendant firm relied on the parent company's WKSI designation to issue securities.²⁴³ In most, the transaction likely would not have gone through at all, or not under the same terms but for the parent company's WKSI status. If the Division of Corporation Finance is concerned that an issuer or its subsidiary would misuse its WKSI status—a concern about recidivism—at least a limited WKSI disqualification in such cases would appear appropriate to reduce the risk of offering fraud.

The second observation is related to the high number of firms that receive waivers from disqualifications resulting from multiple enforcement actions. Several had five or more enforcement actions and associated waivers during the study period. For example, Bank of America has received a bad-actor or WKSI waiver every year since 2006, with the exception of 2012. Although most of Bank of America's violations did not involve issuer-reporting or securities-offering violations, the high number of enforcement actions suggests a larger problem with legal compliance and thus a higher risk of any violation of securities laws. And so, the risk that Bank of America will be involved in fraud in a public or private offering due to its inadequate compliance could justify at least a limited disqualification or, alternatively, closer agency or other external oversight to reduce that risk.²⁴⁴

3. *Are Waivers Denied to Enhance Sanctions?*

Some triggering events for bad-actor and ineligible-issuer disqualifications are related to convictions for securities and financial crimes, many of which have little to do with the quality of a company's disclosures, suggesting a possible sanctioning rationale for disqualifications. Unfortunately,

242. See, e.g., Complaint, SEC v. J.P. Morgan Sec. LLC, 1:11-cv-04206-RMB (S.D.N.Y. June 21, 2011); Complaint, SEC v. Mizuho Sec. USA Inc., 1:12-cv-05550-RA (S.D.N.Y. July 18, 2012); Credit Suisse AG, *supra* note 173.

243. See, e.g., Complaint, SEC v. Citigroup Global Mkts. Inc., No. 1:11-cv-07387-JSR, 827 F. Supp. 2d 328, 330 (S.D.N.Y. 2011), *vacated and remanded*, 752 F.3d 285 (2d Cir. 2014).

244. In fact, the Bank of America settlement related to mortgage securities described in the Introduction to this Article. Robert Schmidt & David Michaels, *Bank of America Granted Penalty Relief in SEC Mortgage Case*, BLOOMBERG BUSINESS (Nov. 20, 2014, 7:31 PM), <http://www.bloomberg.com/news/articles/2014-11-20/bank-of-america-granted-penalty-relief-after-sec-compromise> (“The commission also refused to halt a punishment that precludes the bank from raising capital without jumping through regulatory hoops.”).

without information on denied waivers, one can say very little that is useful about whether the SEC uses (and should use) disqualifications to increase the deterrent punch of its enforcement in situations where maximum penalties are effectively capped. This Section offers a few pieces of circumstantial evidence suggesting that disqualifications are not used to enhance the sanction.

If disqualifications were used only, or primarily, to enhance sanctions, one would expect to see more disqualifications and fewer waivers in cases that do not otherwise signal recidivism risk but where maximum penalties are effectively capped at a low level. Securities laws cap civil fines for firms at \$775,000 per violation, or at the amount of the illicit benefit—a relatively low figure.²⁴⁵ The statutory ceiling on fines does not have much bite in accounting fraud cases, where courts have defined illicit benefit as the amount by which the issuer overstated its earnings, and have authorized the SEC to order civil fines in excess of \$10 billion.²⁴⁶ Conversely, in broker-dealer and investment adviser cases the statute caps the total monetary sanction against the defendant at double the benefit. That the share of broker-dealer and investment adviser waivers in the study is considerably higher than their relative share of enforcement actions suggests that disqualifications are not commonly used as sanction enhancements.²⁴⁷

On the other hand, there is some evidence suggesting that at least sometimes disqualifications are used to enhance the sanction. For one, the Commission has rarely granted waivers to a defendant firm that pleaded guilty or was convicted.²⁴⁸ Perhaps criminal firms present a higher risk for fraudulent disclosures, but that is not obvious. Perhaps criminal charges are categorically different from civil charges and a larger sanction is appropriate, including a disqualification. In a dissent to a waiver granted to a defendant firm that pleaded guilty to financial crimes, Commissioner Stein wrote that disqualification provisions “have the potential for deterrence at large institutions that no one-time financial penalty could ever wield.”²⁴⁹

Relatedly, at least to a settling defendant firm, a disqualification looks very much like an additional sanction. Well-advised firms usually negotiate settlements and waivers concurrently, weighing the costs of both at the same time. Many waiver requests assert that failure to issue the waiver would result in an additional penalty to the firm. At least defendants thus perceive both disqualifications and monetary penalties as sanctions.

245. Maximum fines in accounting fraud cases are much higher. *See, e.g.*, SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 434–36 (S.D.N.Y. 2003) (acknowledging that the SEC could seek a fine between \$10 billion and \$17 billion, but authorizing \$2.25 billion due to bankruptcy law restrictions).

246. *See id.*

247. This is a weak suggestion. I infer that observed waiver grants reveal something about unobserved disqualifications.

248. The Commission granted its first such waiver in a criminal action in September 2013. *See* Stein, *supra* note 13.

249. *Id.*

Finally, guidance on WKSI waivers includes as one of three relevant factors in favor of waiver “hardship in light of the nature of the issuer’s misconduct.”²⁵⁰ This suggests that the SEC considers the proportionality of the disqualification to the underlying offense—a concern that is largely about the appropriate size of sanctions, not about the risk of recidivism. Beyond these observations, however, there is no evidence that the Commission consciously denies waivers to increase the sanction for serious securities violations.

B. Are Disparities Between Large Financial Firms and Others Inherently Unfair?

Table 1 reports that large financial firms receive 81.6 percent of all waivers. They were much more likely than nonfinancial firms and smaller financial firms to receive waivers in more than one enforcement action during the study period.²⁵¹ Large financial firms were also somewhat more likely than nonfinancial firms and smaller financial firms to receive more than one waiver triggered by a single enforcement action, though the difference was not statistically significant. In her dissent to the waiver granted to the Royal Bank of Scotland following its guilty plea for manipulating the LIBOR, Commissioner Stein noted the disparity and criticized it as inherently unfair.²⁵²

The data that the SEC has made available does not make it possible to analyze empirically Commissioner Stein’s concern. It is certainly possible that the Division of Corporation Finance treats large firms, in particular large financial institutions, favorably. A review of enforcement actions for securities offering fraud between 2008 and 2012 did not identify a single enforcement action against a large financial firm that was accompanied by an ineligible-issuer disqualification. The omission is conspicuous in that the SEC itself deems securities offering fraud to signal high risk of future offering fraud.²⁵³

But there are several other plausible explanations for the high share of large financial firms among waiver recipients. First, the ineligible-issuer disqualification has two prongs relevant for issuers and securities-market participants. The first prong makes unavailable the free-writing-prospectus provisions, which issuers and underwriters widely use to generate interest in public offerings.²⁵⁴ The second prong renders the disqualified firm (and its subsidiaries) ineligible for WKSI status. Because only large publicly traded firms are eligible for WKSI status, only they will be affected by both prongs of

250. See Div. of Corp. Fin., Revised Statement, *supra* note 69.

251. The two-sided Chi-squared test was significant at the 1 percent level.

252. Stein, *supra* note 13.

253. See Div. of Corp. Fin., Revised Statement, *supra* note 69.

254. See, e.g., Letter from Paul S. Maco, Vinson & Elkins, to Gerald J. Laporte, Chief, Office of Small Bus. Policy, Div. of Corp. Fin., SEC, Auction Rate Securities Practices (File No. HO-09954), in First Sw. Co., SEC Exemptive Letter (May 27, 2008), <http://www.sec.gov/divisions/corpfin/cf-noaction/2008/firstsouthwest052708-2.pdf> (requesting a waiver from the ineligible-issuer disqualification relating to the free writing prospectus rules).

the ineligible-issuer disqualification. Thus, it is reasonable to expect large firms, both financial and nonfinancial, to comprise the universe of WSKI waiver recipients.

Second, large financial firms usually have thousands of employees, diverse business lines and many subsidiaries, and are subjected to closer SEC oversight than smaller financial firms and nonfinancial firms. The SEC regularly inspects large financial intermediaries, such as broker-dealers and investment advisers, which increases the likelihood of enforcement actions and thus waivers, even if the rate of misconduct is the same.²⁵⁵ Moreover, financial firms' capital-raising, as well as their customer relationships, is regulated: the SEC oversees Goldman Sachs' sales of structured investment products, but does not regulate General Electric's sales of washing machines. Assuming similar rates of misconduct, one would expect more SEC enforcement actions against a large financial firm than against a nonfinancial firm or a smaller financial firm, and hence more waivers.

Third, and relatedly, nonfinancial firms are charged almost exclusively with issuer-reporting and disclosure- and securities-offering violations, which, between 2003 and 2014, amounted to about 45 percent of all enforcement actions and 37 percent of defendants. Financial firms, on the other hand, appear in all categories of securities violations. All else being equal, one would expect nonfinancial firms to receive fewer waivers than financial firms. In addition, as the analysis in Part IV.A suggests, the SEC deems accounting fraud and securities-offering violations red flags for future offering fraud. Consistent with the SEC's view of indicators for recidivism, one would expect fewer nonfinancial firms among waiver recipients—an intuition confirmed by this study.

Fourth, the fact that large financial firms receive a disproportionate share of waivers from automatic disqualifications does not imply that the SEC treats them with kid gloves. Large financial institutions tend to rely on exemptions from securities laws to raise capital,²⁵⁶ to sell financial products, and to provide services for their clients.²⁵⁷ A disqualification affecting a financial institution that manages private funds can also implicate the portfolio companies in which those funds invest.²⁵⁸ A Rule 506(d) bad-actor or ineligible-issuer disqualification will affect multiple different lines of their business, which is often not the case with smaller, specialized financial firms. Moreover, an enforcement action against a subsidiary, such as a majority-owned broker-dealer firm, will trigger a WSKI disqualification for the parent holding company or investment bank. This is so even if the parent company is not

255. See Gadinis, *supra* note 19, at 686–87.

256. See, e.g., OIG BOFA REPORT, *supra* note 66, at 45, 53–54 (showing that Bank of America needed a waiver to raise capital quickly).

257. See, e.g., Oppenheimer Waiver Request, *supra* note 75, at 7–8.

258. See *Report of the Task Force on SEC Settlements*, 47 BUS. LAW. 1083, 1153 (1992).

aware of the misconduct at the subsidiary, and even where the subsidiary's contribution to the bottom line is small. Because larger financial firms tend to be more diversified than smaller financial firms, one would expect that larger financial firms would more easily make the good-cause showing required to receive a waiver—especially since larger financial firms would bear greater hardship if a waiver were denied.

Fifth, since the principal purpose of disqualification is to reduce the risk of recidivism, the presence of alternative mechanisms that reduce the likelihood of repeat misconduct would reduce the need for a disqualification. One such mechanism is closer regulatory oversight. For example, every year, the SEC inspects the twenty largest broker-dealer firms, including their internal controls and risk-management practices.²⁵⁹ Another such mechanism is self-policing. Large financial firms certainly have the resources to implement an effective internal compliance regime that would reduce the risk of offering fraud. However, whether their willingness to self-police is considerably better than the ability of smaller firms to do so is an open question. Even if larger firms have the resources to self-police, they may not have the incentive to do so. Larger firms also have the capacity to do considerably more harm than smaller firms, as a simple function of their size.

Finally, it is possible that the SEC has allowed large-firm defendants to pay higher monetary settlements in lieu of disqualifications. Large financial firms often refuse to settle unless they receive a waiver.²⁶⁰ Even if the practice of fine-and-waive satisfies all involved parties, it raises two concerns from a public policy perspective. First, where large firms repeatedly violate securities laws, alternative policing methods clearly have failed. In cases of serious and repeated misconduct, disqualifications ought to be used against defendant firms regardless of size. And second, even if justified, disparate practices undermine the SEC's image as a fair enforcer of securities laws. In the face of disparate outcomes, this Article recommends that waiver grants and denials be thoroughly explained.

C. *Have Waiver Practices Changed over Time?*

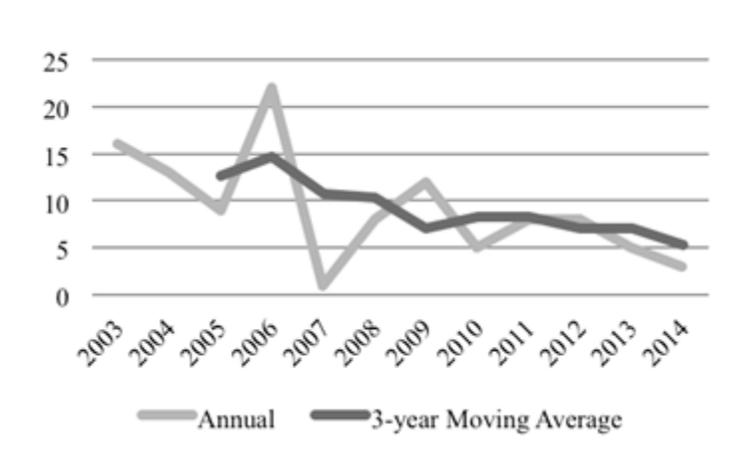
This three-year moving average for old bad-actor disqualifications has declined from 12.7 waivers per year from 2003 to 2005 to 5.3 waivers per year from 2012 to 2014. Indeed, the Division of Corporation Finance did not grant a single waiver from Rule 262 and 505 disqualifications between March 2014 and June 2015.²⁶¹

259. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-1053, SECURITIES AND EXCHANGE COMMISSION: STEPS BEING TAKEN TO MAKE EXAMINATION PROGRAM MORE RISK-BASED AND TRANSPARENT 8 (2007), <http://www.gao.gov/assets/270/265445.pdf>.

260. See, e.g., OIG BOFA REPORT, *supra* note 66, at 46–47 (noting that firms would make their settlement contingent on receiving a waiver).

261. See Div. of Corp. Fin., *Division of Corporation Finance*, *supra* note 199.

FIGURE 1.
RULE 262 AND 505 WAIVERS (2003–2014)



The Division has not given a reason for the decline. Interviews with SEC staff indicate that the Division of Corporation Finance used to grant waivers from Rule 262 and 505 disqualification provisions almost prophylactically, whenever defendant firms requested a waiver, so long as the charged violation was not related to securities offerings or disclosure obligations.²⁶² Faced with greater scrutiny over the exercise of waiver discretion,²⁶³ the Division has likely decided to interpret the “good cause” requirement²⁶⁴ more rigidly. The market for offerings under Regulation A and Rule 505 of Regulation D is currently very small, less than \$1 billion per year.²⁶⁵ Since the cost of the disqualification is thus likely very small for defendant firms, the most plausible explanation for the decline in granted waivers is a stricter application of the requirement to show good cause.

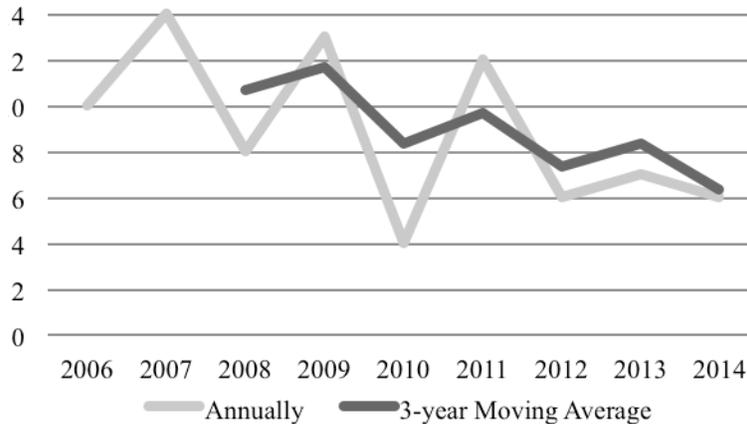
262. Interview with SEC official. The official provided this information on the condition that he or she not be identified.

263. Commissioner Stein first publicly dissented from a grant of waiver at the end of April 2014. See Stein, *supra* note 13. But waiver practices had been scrutinized earlier, most publicly in the Office of Inspector General report. See OIG BOFA REPORT, *supra* note 66.

264. 17 C.F.R. § 230.262 (2015) (requiring that the defendant requesting a waiver show “good cause”); see also OIG BOFA REPORT, *supra* note 66, at 53 (reporting that the Division of Corporation Finance followed objective criteria when deciding whether to grant a waiver).

265. See IVANOV & BAUGUESS, *supra* note 11, at 3, 7 & fig.3. That will likely change after amendments to Regulation A become effective.

FIGURE 2.
WKSI WAIVERS OVER TIME (2006–2014)



The SEC has also granted fewer WKSI waivers over time (see Figure 2). The trend is somewhat less pronounced and the reasons for the decline even harder to identify. The case mix has changed from the period between 2006 and 2009 to the period between 2011 and 2013; there have been fewer accounting fraud cases in the latter period, and more cases against broker-dealers and investment advisers. As a result, assuming all else remained equal, one would expect the number of granted waivers to increase, not decrease. Closer external scrutiny of the Commission's practices could be one likely explanation. Bank of America's pursuit of a WKSI waiver related to proxy fraud in 2010 was controversial and led to an internal investigation by the Office of the Inspector General.²⁶⁶ Public scrutiny increased in 2014 when Commissioner Stein first publicly dissented from a waiver grant.²⁶⁷ Half of the WKSI waivers issued in 2014, three of six, were issued by a Commission order, rather than by the Division of Corporation Finance, suggesting that at least one Commissioner believed that the waiver decision required further discussion. Indeed, many of the votes granting waivers were by a three-to-two Commission vote and several generated public statements by dissenting Commissioners.²⁶⁸ Public dissents are not pleasant for the Commissioners, nor should they be pleasant for rational

266. OIG BofA Report, *supra* note 66.

267. See Public Statement, Comm'r Kara M. Stein, SEC, Dissecting 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. 28, 2014), <http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370541670244>.

268. See, e.g., David Michaels, *Ghosts of 2008 Haunt SEC's 'Outsider' Pushing Tough Rules*, BLOOMBERG (July 21, 2014, 3:00 AM), <http://www.bloomberg.com/news/articles/2014-07-21/ghosts-of-2008-haunt-sec-s-outsider-pushing-tough-rules>; Andrew Ackerman, *SEC Turned 'Blind Eye' to Oppenheimer's Failures, Democrats Say*, WALL ST. J. (Feb. 4, 2015, 4:13 PM), <http://www.wsj.com/articles/sec-turned-blind-eye-to-oppenheimers-failures-democrats-say-1423084427>.

decision makers. Even if the voting coalition is stable, one would expect that rational decision makers prefer to avoid a contentious vote that is required to grant a waiver. As a result, one would expect the number of granted waivers to decline.

That fewer waivers have been granted is not necessarily significant. The underlying enforcement actions may have changed.²⁶⁹ If they have not, the decline is not necessarily a good development. If the Division previously employed waiver criteria that were too lax, or if the defendant firms today pose a higher risk of securities fraud, fewer waivers are appropriate. But if neither, it is just as likely that the Commission and the Division have issued too few waivers in recent years.

The most significant change in waiver practices is not related to their timing, but to their substance. Until very recently, waivers were either granted in full or denied. The first partial waiver on record is a Rule 506(d) waiver granted to Credit Suisse in May 2014.²⁷⁰ The Commission has since issued two more conditional Rule 506(d) waivers,²⁷¹ requiring requesting firms to retain an independent consultant or a law firm to review the defendant firm's practices related to securities offerings.²⁷²

This development is not surprising. Unlike old bad-actor and, to a lesser extent, ineligible-issuer disqualifications, Rule 506(d) disqualification is very significant for a considerable number of defendant firms. This has created tension between the principled approach of denying a waiver to a defendant whose misconduct indicates high recidivism risk, and the defendant's need to receive a waiver to be competitive. Given the increased controversy surrounding waivers and the financial significance of the Rule 506(d) disqualification provision, more partial waivers are likely forthcoming.

269. In the first nine months of fiscal 2015, the SEC has granted ten ineligible-issuer waivers (one waiver to Deutsche Bank AG is a temporary waiver to give the Commission additional time to decide), a considerable increase over prior years. Of the ten, eight disqualifications had been triggered by criminal convictions and pleas. See *No-action, Interpretive and Exemptive Letters*, DIV. OF CORP. FINANCE, SEC, <http://www.sec.gov/divisions/corpfin/cf-noaction.shtml>. The increase is due to the change in the practice of the Attorney General to demand guilty pleas from large financial institutions. See Ben Protess & Jessica Silver-Greenberg, *Justice Department Is Seeking Guilty Pleas by Big Banks in Foreign Currency Inquiry*, N.Y. TIMES (Feb. 9, 2015, 10:00 PM), <http://dealbook.nytimes.com/2015/02/09/u-s-is-seeking-felony-pleas-by-big-banks-in-foreign-currency-inquiry>.

270. See Credit Suisse AG, *supra* note 173 (exempting only certain funds managed by investment advisers wholly owned by Credit Suisse holding company, minority-owned subsidiaries, and certain portfolio companies of the funds—Credit Suisse AG, the parent, and subsidiaries in which it holds a controlling stake, are disqualified).

271. See Bank of Am., *supra* note 227 (conditioning the thirty-month waiver issued to Bank of America on its compliance with monitoring and reporting on its progress); *In re Oppenheimer & Co., Inc.*, Securities Act Release No. 9712 (Jan. 27, 2015), <http://www.sec.gov/rules/other/2015/33-9712.pdf>.

272. See Bank of Am., *supra* note 227; Oppenheimer & Co., Inc., *supra* note 266.

V.

IMPROVING DISQUALIFICATIONS AND WAIVERS

The law and policy underlying automatic disqualifications in securities laws is underdeveloped. Historically, the dominant justification for disqualifications triggered by serious securities violations has been the concern about the risk of fraud where potential victims are the most vulnerable. In 1940, when the original bad-actor disqualification was added to Regulation A, that regulation was the most important mechanism to sell securities without registration. Over time, the significance of Regulation A has declined, and with it, the importance of automatic disqualifications in securities laws.

During the past decade, disqualifications have experienced a revival—first with the ineligible-issuer disqualification in 2005, and recently with the Rule 506(d) bad-actor disqualification in 2013. One additional disqualification provision is already in the hopper. The data presented and analyzed in this Article suggests some patterns in waiver practices: large financial firms receive a disproportionate share of waivers, but waivers in issuer reporting and disclosure cases, as well as in securities-offering cases are rare. The lack of available information from the SEC makes a more thoughtful analysis of its practices difficult, though what is available suggests several avenues for improving issued disqualifications and waivers. This Part makes four sets of recommendations.

A. Disqualified Offerings and Triggers

Assuming that disqualifications are an effective tool to reduce the risk of fraud—an assumption that this Article does not investigate—they should accompany offering types that pose the highest risk of fraud, and should be triggered by events that are most highly correlated with offering fraud. The current regime lacks consistency. Disqualifications are included in only some registration and disclosure exemptions: Regulations A and D, and the automatic shelf registration rules. Even firms convicted of securities fraud remain eligible to make a Rule 144A offering or to use regular shelf registration under Rule 415(a)(1)(x). Issuers raise nearly \$1 trillion dollars per year in reliance on these two rules where SEC oversight is as low as in offerings with disqualifications. Since all of these provisions are based on trusting the firm to comply with the law, it seems difficult to justify that only some are accompanied by disqualifications. If a defendant firm's disclosures cannot be trusted to raise capital under Rule 506 or automatic shelf registration, it is not obvious why regular shelf registration or Rule 144A should be available. If the Commission takes its mission seriously, it should consider adding disqualification provisions to all high-risk safe harbors and registration exemptions.

The second recommendation that would require a rule change relates to events that trigger disqualifications. The lists of triggering events under bad-

actor and ineligible-issuer disqualification provisions are different, without good reason. This can lead to some results that cannot easily be defended. For example, an injunction that relates to a false filing with the Commission will trigger Rule 505 and 262 disqualifications but not an ineligible-issuer disqualification.²⁷³ This is true even where the violation alleged in the complaint amounts to accounting manipulation.²⁷⁴ Since fraud risks for different offerings are very likely correlated, it would make sense to make triggering provisions similar across disqualifications.

Before adding more disqualification provisions, the Commission would be well-advised to evaluate empirically which triggering events are correlated with future offering fraud and which offering exemptions are the most vulnerable to fraud. The Commission already has a solid track record with the empirical approach. It recently implemented an automated system for detecting accounting violations.²⁷⁵ Similarly, the Public Company Accounting Oversight Board has long been working on audit quality indicators, which are measures that provide insight into the quality of financial statements and audits.²⁷⁶ The SEC's newly strengthened Division of Economic and Risk Analysis certainly has the brain and the computing power to assist with the task.²⁷⁷

B. *Waivers for Good Cause*

Ideally, triggering events could be defined so narrowly as to disqualify only truly risky firms, but that is unlikely. Waivers are the Commission's response to soften the bright lines of disqualifications. The decision to grant a waiver from automatic disqualification is related to the decision of when to disqualify. Waiver is appropriate where the risk of recidivism is sufficiently low to warrant it.

The analysis in Parts III and IV of this Article suggests that large financial firms receive a disproportionate share of waivers. This is not necessarily problematic. But the fact that large financial firms often receive waivers year

273. Assurant, Inc., SEC Exemptive Letter (Jan. 26, 2010), <http://www.sec.gov/divisions/corpfin/cf-noaction/2010/assurant012610-3b.pdf>; *In re* GE Funding Capital Mkt. Servs., Inc., Securities Act Release No. 9297, Exchange Act Release No. 66289, 102 SEC Docket 3319 (Feb. 1, 2012), <https://www.sec.gov/litigation/admin/2012/33-9297.pdf>.

274. See SEC, SEC Charges Assurant, Inc. with Improper Reinsurance Accounting, Litigation Release No. 21388, Accounting & Auditing Enforcement Release No. 3109 (Jan. 21, 2010), <https://www.sec.gov/litigation/litreleases/2010/lr21388.htm>.

275. Craig M. Lewis, Chief Econ. & Dir., Div. of Risk, Strategy & Fin. Innovation, SEC, Risk Modeling at the SEC: The Accounting Quality Model (Dec. 13, 2012), <http://www.sec.gov/News/Speech/Detail/Speech/1365171491988>.

276. See, e.g., Memorandum, Pub. Co. Accounting Oversight Bd., Standing Advisory Group Meeting, Discussion—Audit Quality Indicators (May 1, 2013), http://pcaobus.org/news/events/documents/05152013_sagmeeting/audit_quality_indicators.pdf.

277. The Division of Economic and Risk Analysis was created in September 2009 to provide economic analysis necessary to conduct the SEC's activities. See *Economic and Risk Analysis*, DIV. OF ECON. & RISK ANALYSIS, SEC (Apr. 16, 2015), <http://www.sec.gov/dera>.

after year, including when the underlying violation is related to a securities offering, is a cause for concern. At the least, it makes the Commission look insincere and captured, since it has pledged to maintain uniform standards and to apply disqualification provisions fairly.²⁷⁸

In order to grant a waiver, the Commission should insist on credible remedial steps that make disqualification unnecessary. Most waiver request letters describe such steps, but there is no evidence that the SEC verifies whether the representations are true. Where a defendant firm's history of enforcement actions suggests lax internal controls and poor self-policing, the charge to the SEC to protect investors requires more.

C. *The Process for Disqualifications and Waivers*

Disqualifications are automatic, but waivers are not. Currently, the Commission and the Division of Corporation Finance share the task of making decisions regarding waivers. If the rationale for disqualification is minimizing the risk of fraud, then the office with the best information should decide whether or not to grant a waiver. The Division of Corporation Finance's primary function is to oversee issuers' capital-raising activities and to review registration statements, and so it is likely in the best position to assess the risk of offering fraud.

Unlike the Division of Corporation Finance, the Commission usually considers waivers in conjunction with the settlement of the enforcement action. Because of competing considerations the Commission must consider—the desire to secure a settlement that may be contingent on waivers and the statutory command to protect investors from fraud—there is a risk that the Commission's decisions on waivers will not be dispassionate and principled. If, however, the reason for the disqualification is to punish, then the Commission or federal prosecutors should make the ultimate determination regarding the issuance of a disqualification or waiver, not the Division of Corporation Finance. Moreover, if disqualifications are meant to punish, they ought to be imposed in a manner similar to industry bars. Industry bars are direct sanctions, meaning that they (1) are included in the order or judgment, (2) follow a court hearing or an administrative proceeding before an administrative law judge, and (3) include notice and the opportunity to be heard. To better comport with the punishment-based rationale for disqualifications, a similar process should be used to increase the odds that disqualifications will be applied uniformly and fairly.²⁷⁹

278. Disqualification of Felons and Other “Bad Actors” from Regulation D Offerings, 78 Fed. Reg. 44730, 44747–44748 (July 24, 2013) (codified at 17 C.F.R. pts. 200, 230, 239 (2015)).

279. Nevertheless, existing empirical work suggests that large financial firms are much less likely to receive temporary or permanent industry bans from the securities industry than smaller firms, despite having caused comparable levels of harm. See Gadinis, *supra* note 19, at 683.

Regardless of what office decides on waivers, currently the process is opaque. Only waiver grants are made available to the public. Waiver denials and inquiries regarding waivers are not published. Waiver justifications are formulaic and do not suggest that the SEC or the Division conduct a separate investigation into the waiver justifications that the defendant offers. No party other than the defendant and the Division (or the Commission) can participate in the waiver process. The process is shrouded in secrecy. And finally, while waiver grants are published, disqualifications are not. Triggering events are sufficiently vague that an outsider cannot always tell whether an enforcement action triggers disqualification. If disqualifications are to be effective, the SEC should create a centralized database identifying all disqualified individuals and entities. This has not been the practice. The information is necessary both to protect investors from bad actors and to reassure honest companies that they have not inadvertently hired a disqualified firm to assist in their offering.

D. Tailoring Disqualifications

Although most waiver decisions in the last twelve years have been all-or-nothing, the SEC clearly has the authority to issue less than a full waiver.²⁸⁰ Where disqualification is otherwise appropriate to reduce the risk of fraud, but is overbroad, a waiver can be tailored to limit a disqualification in scope or duration, to condition it on the implementation of risk-reduction mechanisms. These options may also be combined.

In fact, the Commission recently granted three partial waivers from Rule 506(d) disqualification. Credit Suisse received a waiver that lifted disqualification for some affiliated companies, but not for the parent company and majority-owned subsidiaries.²⁸¹ Bank of America's waiver is contingent on a satisfactory report by an independent consultant.²⁸² And Oppenheimer agreed to hire a law firm to evaluate its practices to receive a waiver.²⁸³ In addition, instead of barring a defendant from conducting private placements under Rule 506, the Commission could require the defendant to pre-clear offerings or provide additional information to investors before completing a Rule 506 private offering, or it could limit the disqualification to the defendant's own capital-raising but not that of its clients, even though generally applicable rules on private placements include no such requirements.

All these and other possible limitations on waivers are available to the SEC under current law. This Article proposes that the Commission seriously

280. In fact, the SEC has issued conditional waivers in the past. *See, e.g.*, Synergistics, Inc., SEC No-Action Letter, 1981 WL 22803 (May 28, 1981) (waiving Regulation A disqualification for failure to file periodic reports on the condition that the issuer file an annual report for the prior fiscal year, which includes a comprehensive discussion of the issuer's activities for the missing years, and respond to SEC staff comments before commencing the offering).

281. *See* Credit Suisse AG, *supra* note 173.

282. *See* Bank of Am., *supra* note 227.

283. *See* Oppenheimer & Co., Inc., *supra* note 266.

review, reconsider, and revise its disqualification and waiver practices to improve their transparency and consistency in both the rules and their application. Disqualifications can be an effective tool to protect investors and to ensure efficient and competitive capital markets, but they should be deployed transparently, consistently, and fairly.

CONCLUSION

The debate over the collateral consequences of public enforcement for financial misconduct has been surprisingly superficial. Securities enforcement triggers multiple automatic disqualifications in securities laws. This Article is the first to offer a theoretical and empirical analysis of bad-actor and ineligible-issuer disqualifications, and of the SEC's practice of granting waivers from disqualifications.

Disqualifications are useful tools to mitigate the risk of fraud in those capital-raising options under securities laws that minimize disclosure requirements and depend on trusting the issuers to comply. Currently, disqualifications are attached to a seemingly random list of exempt transactions. Moreover, waivers are granted to large financial firms without transparent justification, casting doubt on the SEC's process.

Evidence reported in this study provides some reason for optimism. It suggests that the SEC and its Division of Corporation Finance have developed some clear criteria for denying waivers where the risk of future securities fraud is high, and have applied these criteria consistently, regardless of the identity of the defendant firm. At the same time, this Article recommends that the Commission review its criteria and expand it to disqualify firms whose history of violations suggests a high risk of recidivism. That most waiver recipients are large financial firms invites speculation about unfairness and agency capture, which can undermine the enforcement effort. This Article recommends that the SEC publish and explain all of its decisions of granted and denied waivers, and keep record of disqualified firms and individuals. Increased transparency should not necessarily lead to fewer granted waivers, but should ensure greater consistency and provide reassurance that the Commission is in fact fair. These steps are particularly important as the Commission adds disqualification provisions to an increasing number of rules.

