AMERICAN BANKER

Why We Need the SEC's 'Bad Actor' Waivers

By Thaya Brook Knight

April 6, 2015

For those suspicious of the big banks, there's a new bugbear in town: the Securities and Exchange Commission's practice of granting waivers to individuals and companies that have violated federal securities laws. These waivers permit individuals and firms to participate in securities activities from which they would otherwise be barred. Critics argue that the SEC gives waivers too easily and that the largest financial firms tend to benefit disproportionately, all at risk of enshrining a policy that some firms are "too big too bar."

But there is little evidence to support these claims. On the contrary, the evidence suggests we should welcome these waivers, encourage firms and individuals to request them, and perhaps even narrow the circumstances under which they might be required in the first place.

In general, a company that wants to sell securities must register with the SEC and must comply with a notoriously complex set of disclosure requirements. This registration process alone can cost millions of dollars and require many hours of work from the company, its lawyers and underwriters, and the SEC staff.

Because these requirements are so onerous, federal securities laws include a number of exemptions that permit issuers to use a more streamlined process to offer their securities to investors. These exemptions exist for offerings that are believed to present a lower risk of fraud — for example, because the company has a large public float and is well-known to the market, because the securities are not being offered to the public, or because the offering will be fairly small.

The SEC's bad actor provisions automatically disqualify firms and individuals that break certain securities laws from using these streamlined processes. The idea is that firms that have violated these laws have shown themselves to be dishonest and therefore cannot be trusted to use the exemptions appropriately. The SEC, however, has the authority to waive the disqualification for defendants who can show good cause as to why the disqualification shouldn't apply to them. The decision to grant a waiver is currently made by SEC staff involved in the enforcement action that resulted in the disqualification. Often, the waiver is granted as part of a settlement agreement.

Recently proposed legislation would require SEC commissioners themselves approve any waiver. The SEC would be permitted to grant waivers and exemptions only after a lengthy process, including holding a hearing to give the public an opportunity to comment on the decision. SEC staff would also have to create and maintain detailed public records and a database documenting waiver decisions.

This proposal, if enacted, would generate enormous expense for both the SEC and for market participants. There is no reason to believe that defendants would stop requesting waivers. Each request would therefore entail not only the hearing itself, but extensive preparation by the defendant and the SEC. The SEC staff would also have to review and respond to written public comment.

Then, assuming the process results in more disqualifications — as is surely the bill's intent — SEC staff and the market would be denied the efficiencies created by the exemptions from full registration. A company that has been disqualified will generally either have to raise capital under a more burdensome process, or it might decide that the process is now too expensive and will decide not to raise capital at all.

If the company decides not to raise capital, it will also give up the activities that would have been funded by that capital such as hiring additional workers. And if the company does decide to use full registration, it will mean more work for the SEC. Any increase in disclosures increases the paperwork that SEC staff must review, and any increase in regulatory process increases staff time spent ensuring compliance.

The expense might be justified, of course, if the proposal clearly provided significant benefits such as acting as a fraud deterrent or preventing well-connected firms from receiving unearned privileges. But there is no evidence that the legislation would benefit anyone at all, except perhaps the lawyers and compliance professionals responsible for completing the extra paperwork.

A recent study by Urska Velikonja of Emory University School of Law, cited enthusiastically by the bill's supporters, reported that large firms received 82% of 201 waivers granted between July 2003 and December 2014. But data was unavailable on how many waivers were requested and by whom. The fact that a large percentage of waivers go to large companies is meaningless unless we know how many they requested.

Nor does the study provide evidence that the SEC grants waivers reflexively. Indeed, in a recentspeech SEC chair Mary Jo White said that the agency had approved only about half of two types of bad actor waiver requests over the past year and a half.

Moreover, there is no proof that firms that receive waivers are encouraged to commit further misdeeds. While the study by Velikonja found that some companies receive waivers several years in a row, recidivism is immaterial unless the violations suggest a propensity toward the type of fraud the disqualification was intended to prevent.

In fact, what little we know of the waiver process suggests that we should encourage parties to seek them out. In the same speech, White said that "the sweep of disqualifications is intentionally broad" and that the SEC therefore has "corollary authority to grant waivers or exemptions in order to calibrate the otherwise overly broad effect of disqualifications." Remember that these "overly broad" disqualifications are automatic; the burden is on the party seeking waiver to show that a waiver should be granted.

There may be some merit in asking the SEC to provide better public information about the waiver process, given the dearth of available data. But Congress should take care to ensure that any new record-keeping requirements serve to inform the public and not to discourage defendants from requesting waivers.

If Congress is genuinely concerned about how the SEC currently grants waivers, it might first commission a study from the Government Accountability Office to compile the type of data now lacking. But when the SEC chair herself has told us that the rules are designed to disqualify firms and individuals that pose no real risk to the system, the last thing we need are fewer waivers.

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