GEORGETOWN LAW

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Written Testimony of

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Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets

"Putting Investors First: Examining Proposals to Strengthen Enforcement Against Securities Law Violators"

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Witness Background Statement

Urska Velikonja is a Professor of Law at the Georgetown University Law Center in Washington, D.C., where she teaches courses in securities regulation, securities enforcement, and contracts. She has assembled a database of all SEC enforcement actions filed since fiscal year 2007, a dataset that now includes more than 15,000 defendants and almost thirty enforcement characteristics of each enforcement action. Using that information, Professor Velikonja has authored a half-dozen academic research papers on various aspects of SEC enforcement. The papers include *Reporting Agency Performance: Behind the SEC's Enforcement Statistics*, 101 CORNELL LAW REVIEW 901 (2016); *Public Compensation for Private Harm: Evidence from the SEC's Fair Fund Distributions*, 67 STANFORD LAW REVIEW 331 (2015); *Waiving Disqualification: When Do Securities Violators Receive a Reprieve?,* 103 CALIFORNIA LAW REVIEW 1081 (2015); *Securities Settlements in the Shadows*, 126 YALE LAW JOURNAL FORUM 124 (2016); *Are the SEC's Administrative Law Judges Biased? An Empirical Investigation*, 92 WASHINGTON LAW REVIEW 315; and *Public Enforcement After* Kokesh: *Evidence from SEC Actions*, 108 GEORGETOWN LAW JOURNAL (forthcoming in December 2019).

Before joining the Georgetown faculty in 2017, Professor Velikonja taught at Emory University and the University of Maryland, and visited at the University of Chicago, Duke University and the University of Ljubljana. Before teaching, Professor Velikonja practiced for three years in the Banking, Finance & Capital Markets Group at Schoenherr, an international law firm based in Vienna, Austria, and clerked for Judge Stephen F. Williams of the U.S. Court of Appeals for the D.C. Circuit.

Professor Velikonja holds a J.D., *magna cum laude,* and an LL.M. from Harvard Law School, and an LL.B. from the University of Ljubljana.

Professor Velikonja has not received any federal grants or any compensation in connection with her testimony; furthermore, she is not testifying on behalf of any organization. The views expressed in her testimony are solely her own.[1]

1. I would like to thank Alejandro J. García for research assistance with this testimony. Portions of the discussion in Parts I and II of this written testimony draw from my forthcoming article *Public Enforcement After* Kokesh: *Evidence from SEC Actions*, 108 GEORGETOWN LAW JOURNAL (forthcoming in December 2019). Discussion in Part III draws heavily from my published article *Waiving Disqualification: When Do Securities Violators Receive a Reprieve?,* 103 CALIFORNIA LAW REVIEW 1081 (2015).

Ms. Chairwoman Maloney, Ranking Member Huizenga, Members of the Subcommittee

Thank you for inviting me to testify at this hearing. My name is Urska Velikonja. I am a Professor of Law at the Georgetown University, where I teach courses on securities regulation and enforcement, among other topics. I am here today solely as a scholar and am not testifying on behalf of any entity.

The proposals that the subcommittee is considering today do much more than "strengthen enforcement against securities law violators;" the proposed legislation also codifies existing enforcement remedies that are threatened by recent U.S. Supreme Court decisions. Inaction will significantly impair the efficiency and honesty of our capital markets.

Allow me to explain. You have in front of you two kinds of legislative proposals. The first kind are improvements to the existing regime: rewarding PCAOB whistleblowers to encourage early reporting, improving the process for granting waivers from bad actor disqualifications, and increasing the civil fines that the SEC can impose. The second kind of legislative proposals codify an existing practice in SEC enforcement, now decades-old, such as disgorgement in civil actions. These practices are threatened by recent Supreme Court decisions in *Kokesh v. SEC*[2] and *Gabelli v. SEC*[3]. These cases threatens not only SEC disgorgement but also similar remedies sought by the SEC and its sister enforcement agencies such as the CFTC, federal banking regulators, and the FAA, among others, but I will focus my remarks on the SEC alone. As a result, failure to act and adopt the proposed amendments does not preserve the status quo. Rather, inaction would significantly hamper SEC enforcement since lower courts applying these new decisions are blocking long-standing agency practices.

My comments are divided in three parts. In Part I, I discuss the Discussion Drafts that propose increasing civil fines and codifying equitable relief in civil actions. In Part II, I supply data on the impact of short limitations periods on SEC enforcement, and suggest that an increase in the limitations period is necessary. Finally, in Part III, I provide data on SEC's bad actor disqualification and waiver practices. Specifically, my comments suggest that the proposed amendments are necessary to bring transparency and accountability to the waiver process.

I. STRENGTHENING RELIEF IN SEC ENFORCEMENT

Securities laws require information disclosure, ban trading on inside information, and prohibit fraud. These laws are necessary but not sufficient by themselves. Consistent and strong enforcement of those laws is necessary as well. The United States' securities enforcement program is the envy of the developed and developing world, and the SEC has served as a model for securities regulators around the globe.[4] That success is a product of impressive foresight by its New Deal creators and the ingenuity of its subsequent caretakers, in particular its first enforcement directors Irving Pollack and Stanley Sporkin.

2. 137 S. Ct. 1635 (2017).
3. 568 U.S. 442 (2013).
4. For example, the OECD anti-bribery program is modeled on the U.S. anti-bribery program. The Chinese securities regulator, the China Securities Regulatory Commission, has copied the SEC.

Recent Supreme Court decisions, in particular *Kokesh*, threaten that legacy. The four Discussion Drafts in front of you today propose to modify the legal and equitable relief available to the SEC. All four propose new and increased sanctions, whereas Representative McAdams' Discussion Draft also codifies the SEC's right to seek disgorgement in civil actions, which is threatened by the Supreme Court decision in *Kokesh*. The Drafts also propose expanding the universe of available remedies. I will first address the codification of disgorgement and then the need for increased sanctions.

A. Codifying Disgorgement in Civil Actions

When originally enacted in the 1930s, securities laws did not authorize the SEC to obtain any monetary relief. The SEC sometimes obtained compensatory relief in settlements, but did not seek monetary relief in court until the 1960s.[5] Beginning in the 1960s, the SEC asked courts for relief ancillary to injunctions, including disgorgement, to bolster its enforcement efforts.[6] Other equitable remedies sought by the SEC include restitution, asset freezes, and receivership. Most of these remedies are not expressly authorized by securities laws, yet they have become the mainstay of securities enforcement. Over time, settling securities defendants have agreed to tailored relief, crafted to improve compliance and protect capital markets from future misconduct. Such relief includes appointing independent monitors and consultants, requiring defendants to review internal policies and submit reports to the SEC, even requiring a public company to pre-clear the CEO's Twitter activity.[7]

Since these remedies are not explicitly authorized by the securities laws, the question of their legality exists, although it has been largely theoretical until recently. The U.S. Supreme Court has not decided the issue but did signal disapproval in a footnote in *Kokesh.*[8] The SEC is authorized by statute to seek in civil actions only injunctions, officer and director bars, civil monetary penalties, penny stock bars, and equitable relief.[9] The statutes authorize the SEC to seek disgorgement in an administrative proceeding,[10] but there is currently no statutory provision that authorizes disgorgement in the majority of enforcement actions, that the SEC files in court.

This omission does not imply that legislative drafters intended for the SEC to obtain disgorgement only in administrative proceedings but not in court. Rather, courts had "routinely ordered disgorgement" in SEC actions well before 1990,[11] and so both the SEC and congressional legislators discussing the then-proposed Securities Enforcement Remedies and Penny Stock

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5. *See* John D. Ellsworth, *Disgorgement in Securities Fraud Actions Brought by the SEC*, 1977 DUKE L.J., 641, 642-43 (1977) (listing SEC settlements from 1943 and 1945 that resulted in investor compensation despite the lack of statutory authority to order monetary relief).

6. In 1965, the SEC sued Texas Gulf Sulphur Co. and its insiders for accounting fraud and insider trading, and sought restitution. In 1971, the Second Circuit decision in SEC v. Texas Gulf Sulphur Co. recognized that the SEC had equitable power to "require[] corporate insiders who traded on material nonpublic information to disgorge their illegal trading profits." 446 F.2d 1301 (2d Cir. 1971).

7. SEC v. Elon Musk, 1:18-cv-8865 (2d Cir., Apr. 26, 2019).

8. In footnote 3 of the *Kokesh* majority opinion, the Supreme Court questioned the legality of disgorgement in SEC civil actions but did not decide the issue. See Kokesh, 137 S. Ct. at 1642 n.3.

9. Section 21(d) of the Securities Exchange Act.

10. Pub. L. No. 101-429, 104 Stat. 931, 937-40, §§ 202(a), 203 (codified at 15 U.S.C. §§ 78u-2, 78u-3 (2013)).

11. *See* Donna M. Nagy, *The Statutory Authority for Court-Ordered Disgorgement in SEC Enforcement Actions*, 71 S.M.U. L. REV. 895, 910-11 (2018) (citing to Hearings Before the Subcomm. on Sec. of the Comm. on Banking, Hous. and Urban Affairs on S. 647, 101st Cong. 426 (1990) (written responses of Richard Breeden, Chaiman, SEC)).

Reform Act assumed that the SEC did not need statutory authorization to seek equitable relief such as disgorgement.[12] More recently, the Dodd-Frank Act in 2010 amended the Commodity Exchange Act to specifically authorize the CFTC to obtain equitable restitution and disgorgement. No such authorization appeared necessary for the SEC because the practice of disgorgement in civil actions was long-standing. Furthermore, Congress endorsed the practice in section 922 of the Dodd-Frank Act which authorizes the SEC to reward whistleblowers based on "any monies, including penalties, disgorgement, and interest" ordered in "any judicial or administrative action."

In *Kokesh,* the Supreme Court held that disgorgement of ill-gotten gains was a penalty, not an equitable remedy. Typically, courts cannot impose penalties without statutory authorization. Thus, by implication, if disgorgement is a penalty, the SEC has no authority to seek disgorgement in actions filed in court. No court has reached that conclusion yet, but it is only a matter of time. Inability to seek disgorgement in court would severely hamper SEC enforcement. The SEC routinely seeks disgorgement in enforcement actions filed in court. Disgorgement is the second most commonly-imposed relief in SEC enforcement actions. Disgorgement was ordered in 54.4 of percent of resolved cases filed in fiscal years 2010 to 2018 (56.3 percent of cases in which the SEC prevailed).[13] Only civil fines are imposed more often.[14] Total disgorgement orders during the period amounted to $145 billion, dwarfing civil fines that amounted to $9.8 billion. Of that total, more than $140 billion in disgorgement was imposed in civil actions. These figures include disgorgement that is ordered in SEC enforcement actions, but is deemed satisfied with payments in parallel criminal cases or credited for payments in parallel criminal or civil actions. Even if amounts credited or deemed satisfied were excluded, disgorgement represents the majority of monetary penalties imposed during the period ($13 billion or 57 percent of aggregate monetary penalties), and the bulk of that disgorgement, $9.9 billion, was imposed in civil actions.[15]

There are no ready alternatives to disgorgement in civil actions. It is unlikely that the SEC could divert all disgorgement cases to administrative proceedings in lieu of bringing them in court. Although the Dodd-Frank Act authorized the SEC to bring any of its actions in administrative proceedings,[16] the Supreme Court's decision in *Lucia v. SEC*[17] upended administrative adjudication at the SEC. Only a few new contested cases have been filed in administrative proceedings since March 2018, and a case challenging the constitutionality of ALJ removal protections is currently pending in district court.[18] Unless civil fines are substantially increased as proposed in Representative Porter's Discussion Draft "Stronger Enforcement of Civil Penalties Act of 2019,"[19] the SEC cannot substitute civil fines for disgorgement. Civil fines are capped at the defendant's pecuniary gains from violations, which would merely deprive the violator of that gain. Restitution could substitute for disgorgement in cases where the SEC seeks to distribute the funds, but the relief is of limited utility where the defendant did not gain at the victims' expense

12. *See id*.

13. The tally includes individual and joint-and-several liability.

14. An injunction or a cease-and-desist order is imposed in almost every case resolved in favor of the SEC. Civil fines were imposed in 4,183 cases (61.2% of resolved cases and 66.3% of cases in which SEC prevailed).

15. *See* Velikonja, *Public Enforcement After* Kokesh: *Evidence from SEC Actions*, 108 GEORGETOWN LAW JOURNAL (forthcoming in December 2019), at 19-20 & tbl. 1.

16. *See* Dodd-Frank Act § 929P(a)(1), 124 Stat. 1376, 1862 (2010).

17. 138 S. Ct. 2044 (2018).

18. *See* Lucia v. SEC, Complaint for Declaratory and Injunctive Relief, Civ. Action No. 18cv2692 DMS JLB (D.D.C., Nov. 28, 2018).

19. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-enfcivpen.pdf.

(e.g., accounting fraud) or where victims losses are not easily traced to defendant's gain (e.g., foreign bribery, insider trading).

Representative McAdams' Discussion Draft codifies equitable relief in SEC enforcement actions, including disgorgement.[20] The proposal is modeled on section 6c of the Commodities Exchange Act, which authorizes the CFTC to seek equitable relief in actions filed in district court.[21] The Discussion Draft adds officer and director bars, injunctions, and a catch-all provision for other equitable relief. That addition is necessary because at least two district courts have opined that injunctions, too, are "penalties" under *Kokesh,* as are professional bars[22] and potentially officer and director bars.[23] If that situation were not remedied, the SEC could not impose those types of relief for violations older than five years.[24] The codification proposed in the McAdams Discussion Draft is essential for maintaining the status quo in securities enforcement.

B. Strengthening Enforcement Penalties

In addition, Discussion Drafts by Representatives McAdams,[25] Porter,[26] and Sherman[27] propose new remedies, that include equitable restitution and trading prohibitions for foreign firms listed on U.S. exchanges, unless the PCAOB can regularly inspect their auditors; and expanded remedies, including (1) civil fines that are based on investor losses and not merely the violator's ill-gotten gains, (2) civil fines equal to the treble the ill-gotten gain (as is already available in insider trading cases), and (3) increased sanctions for recidivists.

I will limit my remarks to the expanded remedies proposed in Representative Porter's Discussion Draft "Stronger Enforcement of Civil Penalties Act of 2019."[28] The Discussion Draft proposes increasing civil fines across the board, but most significantly for violations that generate large illicit gains or produce substantial investor losses. Importantly, the proposal recognizes that securities violations vary considerably, and not all result in zero sum transfers from victims to wrongdoers. Some violations, such as accounting fraud, produce large investor losses with only minimal gain to wrongdoers. Others produce large gains to wrongdoers without easily identifiable victims who lost money, such as insider trading in publicly-traded securities. Still other securities violations are so lucrative that even monetary penalties in the hundreds of millions of dollars fail to deter, for example foreign bribery.[29] The one-size-fits-all approach currently enacted into law does not fit the varied universe of securities violations well. The "Stronger Enforcement"

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20. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-sea34.pdf.
21. 7 U.S.C. § 6c(d)(3).
22. Johnson v. SEC, 87 F.3d 484 (D.C. Cir. 1996); Saad v. SEC, 873 F.3d 297 (D.C. Cir. 2017).
23. Gabriel K. Gillett, Howard S. Suskin, and Adam G. Unikowsky, *After* Kokesh, *Does the SEC Have a New Time Limit for Claims Seeking an Officer or Director Bar?,* AM. BAR ASS'N (Aug. 25, 2018), https://www.americanbar.org/groups/litigation/committees/securities/articles/2018/summer2018-after-kokesh-does-the-sec-have-a-new-time-limit-for-claims-seeking-an-officer-or-director-bar/.
24. *See* SEC v. Cohen & Baros, 332 F.Supp.3d 575 (E.D.N.Y. July 12, 2018); SEC v. Jones, 300 F.Supp.3d 312 (D. Mass. Jan. 5, 2018).
25. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-sea34.pdf.
26. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-enfcivpen.pdf; https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-cmaa.pdf.
27. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-forcoacc.pdf.
28. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-enfcivpen.pdf.
29. Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, Foreign Bribery: Incentives and Enforcement (Apr. 7, 2017), https://ssrn.com/abstract=1573222 (showing that foreign bribery is profitable even for firms that are caught by U.S. regulators and ordered to pay fines).

Discussion Draft takes these variations into account and provides alternative measures for setting civil fines to deter appropriately:

(1) Modest increases for first- and second-tier penalties.
(2) Substantial increases for third-tier penalties for most serious violations:
    a) The proposal categorizes as most serious not only violations that produce substantial losses to investor but also those that generate substantial pecuniary gains. As noted, not all securities violations generate substantial investor losses: foreign bribery, for example, typically does not generate investor losses, but does produce substantial gains for offenders.
    b) The proposal offers three alternatives methods to set civil fines. In addition to a per-violation fine, the proposal adds aggregate investor losses or treble pecuniary gain as alternative measures of civil money penalties.
(3) Adds fourth-tier civil fines for recidivists.

The proposed third-tier penalties are a significant improvement over existing rules. The provisions add flexibility and enable the SEC to punish and deter the most serious violations. Existing rules cap civil fines in court at the gross amount of pecuniary gain or $775,000 per violation. Because serious securities violations do not always produce large pecuniary gains, the SEC has sometimes had to engage in creative statutory interpretation to obtain appropriate relief. In 2012, for example, the SEC fined BP plc $525 million for understating the amount of oil that was leaking from the damaged oil well after the Deepwater Horizon explosion. BP plc made no obvious "amount of pecuniary gain" from its violations, so the negotiated fine was a multiple of the per-violation fine for third-tier violations. Under the rules in force at the time, the maximum third-tier fine was $725,000 per violation. The SEC's complaint identified perhaps a half-dozen materially misleading statements, each a violation. But the total fine of $525 million would require the SEC to have found 724 violations.

The reason that SEC could be creative here is because securities laws do not define what constitutes a "violation." If BP's series of misleadingly-low estimates were treated as a "course of conduct" and thus a single securities violation, the maximum civil fine would be $725,000. If each misleading statement were treated as a violation, then the maximum civil fine would be 6 times $725,000, or $4.35 million. If the communication of a misleading statement to each investor constitutes a violation, then the potential fine increases by a factor of several million, certainly well more than $525 million that the SEC ultimately imposed. Creative math was possible because BP settled with the SEC. The SEC has been less successful in contested cases. It has persuaded some judges to multiply the fine by the number of injured investors when their number was small, but never when it was large.[30] But the SEC's methodology is ad hoc and somewhat unpredictable, and is certainly susceptible to a Supreme Court challenge.

The Porter Discussion Draft does not define a "violation" either, but rather offers a superior solution by adding another method to set civil fines. In addition to capping civil fines at the gross amount of pecuniary gain or $775,000 per violation, it authorizes the SEC to base the civil fine on

30. See Jonathan N. Eisenberg, *Calculating SEC Civil Money Penalties*, HARV. L. SCH. FORUM ON CORP. GOV. & FIN. REG. (Jan. 24, 2016), https://corpgov.law.harvard.edu/2016/01/24/calculating-sec-civil-money-penalties/.

aggregate investor losses, which is both, more predictable and consistent with optimal deterrence theory.[31] That formula would permit the civil fine that the SEC imposed on BP plc.

The Discussion Draft also increases the cap on third-tier civil fines to treble the gross pecuniary gain. Optimal deterrence theory contends that merely depriving the violator of the gain does not deter misconduct.[32] Instead, the amount must be adjusted by the likelihood of detection. If an offender gains $100 with each violation, is caught only once every five times, and is ordered to pay a $100 fine when prosecuted, she and other bad actors have the incentive to continue breaking the law since they are ahead by $400, on average, by the time she has been caught once. Detection rates for securities violations are notoriously difficult to estimate,[33] but are almost certainly well below 50 percent which the existing civil penalty regime implicitly presumes.[34] The best estimate suggest that only 25 percent of serious accounting frauds are prosecuted.[35] Other violations are prosecuted even less often: only 6.4 percent of long-lasting foreign bribery schemes are prosecuted.[36] Treble gain at least enables the SEC to increase civil fines in enforcement actions where detection rates are notoriously low, such as for FCPA violations. Moreover, in insider trading cases the SEC can obtain civil fines capped at "three times the profit gained or loss avoided as a result of such unlawful purchase, sale, or communication."[37] Other securities violations are detected at rates as low as insider trading, and a civil fine that triples the gain is an improvement over the status quo. Finally, and least importantly, to the extent that the statute of limitations cannot be extended to capture all violations, larger civil penalty authority could make up for some of the deterrence shortfall introduced by short limitations periods.

II. STATUES OF LIMITATIONS AND REPOSE

Two Discussion Drafts propose modifying the statutes of limitation for penalties and remedies in securities enforcement actions, and I support both. Representative Gonzalez's Discussion Draft extends the limitations period for civil monetary penalties from five to ten years.[38] Representative McAdams' Discussion Draft authorizes the SEC to seek disgorgement, restitution, injunctions, and officer and director bars in court, and further defines all as equitable relief.[39] As such, it exempts these remedies from the federal five-year statute of limitations and subjects them to a more flexible equitable limitations period of laches (i.e., unreasonable delay in the pursuit of legal claims).

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31. *See* Gary Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968) (arguing that violators will be deterred if they bear the social cost of their wrongdoing, adjusted for the likelihood of detection).

32. *See id.*

33. *See* Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887, 1911 (2013) (reporting estimates of detected accounting fraud that range from 2.39 percent to 100 percent).

34. The maximum total monetary penalty under existing regime is double the gross pecuniary gain, disgorgement plus a third-tier civil fine, which implies a 50 percent detection rate.

35. *See* Alexander Dyck, Adair Morse & Luigi Zingales, How Pervasive Is Corporate Fraud?, at (Aug. 2014) (unpublished manuscript), available at http://faculty.haas.berkeley.edu/morse/research/papers/DyckMorseZingalesPervasive.pdf.

36. Karpoff, Lee & Martin, *supra* note 29, at 5.

37. Section 21A(a)(2) of the Securities Exchange Act.

38. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-sol.pdf.

39. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-sea34.pdf.

With few exceptions, all penalties in SEC enforcement are currently subject to the federal catch-all five-year statute of limitations under section 18 U.S.C. § 2462, which applies to any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise."[40] The five-year limitations period applies only to claims for legal relief, such as civil fines and forfeiture orders, but not to equitable relief.[41] Under *Gabelli v. SEC,*[42] a 2013 Supreme Court decision, the limitations period under section 2462 runs from when the violation is committed, and not from when the SEC discovers (or reasonably could have discovered) the violation.[43] The five-year limitations period applies only to claims for legal relief, such as civil fines and forfeiture orders, but not to equitable relief.[44] The Supreme Court held in the 2017 case *Kokesh* that disgorgement of ill-gotten gain was a penalty, contrary to longstanding agency practice, and thus subject to the five-year limitations period. As a result, Charles Kokesh was able to keep all but $5 million of $35 million he embezzled from his investors.[45]

The section 2462 limitations period creates two significant issues for SEC enforcement. First, despite considerable investment in market oversight, most securities violations remain very difficult to detect and take a long time to investigate.[46] As a result, 37 percent of SEC enforcement actions include violations that took place outside the five-year limitations period. There is considerable variation among types of violations: insider trading is typically prosecuted within the limitations period whereas foreign bribery, accounting fraud, and cases against financial intermediaries are not.[47] Second, because section 2462 was not drafted specifically for SEC enforcement, the distinctions it draws among remedies are artificial. Penalties and forfeiture are subject to the five-year limitations period, whereas non-punitive relief is not. In *Kokesh*, the Supreme Court attempted to distinguish between penalties, subject to the limitation, and non-penalties, which are not. It held that disgorgement was a penalty because (1) it is imposed as a consequence of violating public laws,[48] (2) it seeks to deter violations which is "inherently punitive";[49] and (3) it is only sometimes paid to compensate defrauded investors.

But the Court did not explain what other types of relief might be punitive and therefore subject to the limitation, which creates considerable uncertainty and has produced unnecessary litigation for defendants and federal enforcement agencies alike.[50] So far, two district courts have opined that SEC injunctions, the archetypal equitable relief, are penalties under the vague *Kokesh* test and thus subject to the five-year limitations period,[51] as are professional bars.[52] If these

40. 28 U.S.C. § 2464.

41. *See* Meeker v. Lehigh Valley R.R. Co. 236 U.S. 412, 423 (1915).

42. 568 U.S. 442 (2013).

43. Gabelli, at 454.

44. *See* Meeker v. Lehigh Valley R.R. Co. 236 U.S. 412, 423 (1915).

45. The disgorgement award against Charles Kokesh was reduced from $35 million to $5 million. *See* SEC v. Charles Kokesh, Amended Final Judgment, No. 09-cv-1021 SVM/LAM (Oct. 31, 2018).

46. SEC investigations take on average two years to complete. As a result, a violation that took place more than three years before the SEC opened an investigation will be time-barred.

47. Urska Velikonja, *Public Enforcement After* Kokesh, *supra* note 15.

48. Kokesh, at 1643.

49. *Id*.

50. For example, restitution, which is always used to compensate investors, is often imposed in criminal and civil enforcement actions for violations of public laws and also deters. The fact that the government has the right to investigate violations at all will deter some violators, but that does not mean that investigations are penalties.

51. SEC v. Cohen & Baros, 332 F.Supp.3d 575 (E.D.N.Y. July 12, 2018); SEC v. Jones, 300 F.Supp.3d 312 (D. Mass. Jan. 5, 2018).

52. Saad v. SEC, 873 F.3d 297 (D.C. Cir. 2017).

decisions are upheld, securities violators could defraud investors with impunity, so long as they avoid prosecution for five years.

A. Extending the Statute of Limitations of Civil Monetary Penalties in SEC Enforcement Actions **(Gonzalez Discussion Draft)**

The Discussion Draft proposed by Representative Gonzalez extends the limitations period for civil monetary penalties from five to ten years. I believe that it would be a considerable improvement over the status quo.

My study of all SEC enforcement actions filed in fiscal years 2010 to 2018 shows that 37 percent of SEC enforcement actions include violations older than five years.[53] A large majority of those (34.2 of all cases and more than 92 percent of time-barred cases) prosecute schemes that took place over a long period of time, in which some of the violations took place within and the rest outside the five-year limitations period. In a small percentage of cases, 2.8. percent, *none* of the alleged violations took place *within* the five-year limitations period.[54] Significantly, the relative share of cases that allege violations *entirely within* the five-year limitations period has gradually declined during the study period, from 70 percent in FY 2010 and 2011 to 50 percent in FY 2018.[55]

The limitations period does not affect all securities violations equally. As shown in the table below, the SEC is able to detect and prosecute insider trading and market manipulation very quickly: only 12.2 percent of insider trading cases and 23.4 percent of market manipulation cases are affected by section 2462's limitations period. The SEC, FINRA and exchanges actively monitor public markets where these violations typically take place, so many are immediately revealed.[56] Most insider trading prosecutions are initiated after an announcement of a tender offer that is accompanied by unusual trading patterns.[57] Once the SEC secures trading information from brokerages, it is only a matter of time before the enforcement staff find traders who received tips, freeze their accounts when necessary, and serve them with a complaint. In fact, the SEC has filed enforcement actions for insider trading within days of the violation.[58] Similarly, unusual increases in trading volumes and in prices of otherwise obscure pink-sheet stocks allow the staff to identify pump-and-dump schemes early, and to prosecute perpetrators quickly.

53. Urska Velikonja, *Public Enforcement After* Kokesh, *supra* note 15, at 28.

54. Many of defendants in such cases signed tolling agreements with the SEC to stop the limitations clock. *See id.* at 38-40.

55. The share of cases entirely inside the five-year SOL is as follows: FY 2010 (70.5%), FY 2011 (71.3%); FY 2012 (68.4%); FY 2013 (69.1%); FY 2014 (66.2%); FY 2015 (59.9%); FY 2016 (56.5%); FY 2017 (59.4%); FY 2018 (51.4%).

56. *See* Michael A. Perino, *Real Insider Trading*, St. John's School of Law Legal Studies Research Papers Series No. 19-5, at 28 tbl. 3, *available at* https://ssrn.com/abstract=3338536.

57. *See id*. at 47 tbl. 12 (showing that 67 percent of insider trading prosecutions involve announcements of M&A activity).

58. See e.g., SEC v. Zhichen Zhou & Yannan Liu, Complaint, No. 1:15-cv-8796-TPG, at 2 (Nov. 9, 2015) (alleging that Zhou sold shares on announcement of a merger on November 2, 2015, one week before the SEC filed the complaint); SEC v. Alda Ltd. et al., Complaint for Violations of Federal Securities Laws, at 2-6, Civ. Action No. 2:17-cv-1287 (Feb. 24, 2017) (alleging that traders bought shares between February 10 and 14, 2017, and sold them on February 14 & 15, 2017, after Fortress acquisition was announced).

TIMING OF VIOLATION BY SUBJECT MATTER

	Entirely Inside SOL	Partly Outside SOL	Entirely Outside SOL
Insider Trading	708 (87.8%)	82 (10.2%)	16 (2.0%)
Market Manipulation	736 (76.3%)	216 (22.4%)	13 (1.3%)
Securities Offering	1737 (69.1%)	820 (31.7%)	32 (1.2%)
Public Finance Abuse	212 (65.4%)	96 (29.6%)	16 (4.9%)
Issuer Reporting	657 (53.6%)	522 (42.6%)	47 (3.8%)
Investment Adviser, Transfer Agent & SRO	733 (51.5%)	642 (45.1%)	48 (3.4%)
Broker-dealer	301 (48.9%)	296 (48.1%)	18 (2.9%)
FCPA	6 (4.0%)	107 (71.8%)	36 (24.2%)
All	5167 (63.0%)	2802 (34.2%)	228 (2.8%)

By contrast, foreign bribery may never come to light without a whistleblower complaint, and typically takes a long time to prosecute because the evidence must be gathered abroad and often translated. Cases against financial intermediaries, including broker-dealers, investment advisers, transfer agents, and SROs, too, are more likely than the median securities case to include older charges: half of cases against financial market intermediaries include violations older than five years. They include long-lasting customer abuse schemes like those by Charles Kokesh, Bernard Madoff,[59] and Allen Stanford,[60] but also sophisticated and well-concealed violations by Wall Street firms.[61] The reason for the delay is that violators can take steps to hide their actions.

The five-year limitations period effectively caps at relatively low levels civil fines that the SEC can obtain in the types of cases that take a long time to detect and to investigate, including the most serious Ponzi schemes, Wall Street frauds, and accounting frauds. The Kokesh case nicely illustrates the point. Charles Kokesh owned and controlled two registered investment advisory firms. From 1995 until 2007 when the funds were dissolved, Kokesh embezzled investors' funds, paid himself unearned performance fees, and reimbursed unauthorized expenses, ultimately misappropriating about $35 million from more than 21,000 investors.[62] After the jury found Kokesh liable for fraud, the SEC asked the district court to impose a third-tier civil fine equal to the gross amount of pecuniary gain as a result of the violation, a total of $34,927,329.[63] Because

59. *See* U.S. Sec. & Exch. Comm'n, SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme, No. 2008-293 (Dec. 11, 2008), https://www.sec.gov/news/ press/2008/2008-293.htm.

60. *See* U.S. Sec. & Exch. Comm'n, SEC Charges R. Allen Stanford, Stanford International Bank for Multi-Billion Dollar Investment Scheme, No. 2009-26 (Feb. 17, 2009), https://www.sec.gov/news/press/2009/2009-26.htm.

61. For example, in 2016 Merrill Lynch was ordered to pay $415 million in monetary penalties, including $57 million in disgorgement because it used cash in custodial accounts "to fund its own business activities through a series of increasingly complex trades" and allowed "clearing banks to hold general liens over tens of billions of dollars of securities owned by its customers", contrary to clear prohibitions. Merrill Lynch, Pierce, Fenner & Smith Inc. & Merrill Lynch Professional Clearing Corp, Order Instituting Administrative and Cease-and-Desist Proceedings and Imposing Remedial Sanctions and a Cease-and-Desist Order, Exchange Act Release No. 78,141 (June 23, 2016).

62. Sec. & Exch. Comm'n v. Kokesh, Complaint, 1:09-cv-1021 (D.N.M., Oct. 27, 2009).

63. *See* SEC v. Kokesh, Plaintiff's Motion for Entry of Final Judgment Against Defendant Charles R. Kokesh, at 9-10, Civ. No. 09-cv-1021-SMV-LAM (Dec. 2, 2014).

of the limitations period, the district court ordered Charles Kokesh to pay a much smaller amount as a civil fine, $2,354,593, which equaled "the amount of funds that [Kokesh] himself received during the limitations period" (i.e., after October 28, 2004).[64] Extending the limitations period for civil monetary penalties to ten years would enable the SEC to punish more of the misconduct it discovers and would not allow defendants to avoid prosecution or a portion of the fine because a portion of charged violations happens to be older than five years.

There are several standard policy arguments in favor of limitations periods, but none undermine the proposed amendment. The first is that limitations periods provide repose, that is "certainty about a plaintiff's opportunity for recovery and a defendant's potential liabilities."[65] A ten-year limitations period as proposed in the Discussion Draft provides as much certainty as a five-year limitations period. In fact, the more precise definition of civil monetary penalties in the Discussion Draft provides more certainty than the imprecise definition of "penalties" offered in *Kokesh.*

The second policy argument in favor of limitations periods is that they "promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared."[66] To the extent that evidence deteriorates over time, a shorter limitations period is favorable to a longer one, but that is typically balanced against the policy goals of deterrence and retribution. There is no statute of limitations for murder, for example, even though unreliable eyewitness evidence is often used to prove murder. Documentary evidence, which is predominantly used in securities enforcement actions,[67] typically does not deteriorate with time, although the ability to explain the document's context may.

But if fresh evidence is the reason for a short limitations period, statutes are a poor mechanism for achieving that objective. There is no rule of evidence that bars the SEC from using older evidence to prove more recent violations. Fraudulent schemes that the SEC prosecutes are often long-lasting. Charles Kokesh, for example, began to steal from his clients fourteen years before the SEC sued him and continued to do so until about two years before suit. Bernard Madoff's and Allan Stanford's schemes, also, lasted for several decades. When the SEC set out to prosecute long-lasting schemes, it can present to the judge and the jury evidence of when Kokesh began stealing and how he stole funds over time. In the case against Kokesh, the limitations period became relevant only when the district court set out to calculate monetary penalties. Only then did the court choose to ignore financial statements and receipts showing embezzlement that were older than five years at the time the SEC filed suit. Moreover, if the objective of a limitations period is to ensure fresh evidence at sanctioning, it fails. The initiation of a legal proceeding tolls the statute of limitations. As long as enforcement proceedings begin within the limitations period, the age of evidence at sanctioning is irrelevant. In the case of Charles Kokesh, the district court set monetary penalties in 2015, almost six years after the SEC filed suit. By that point, it considered evidence that was almost eleven years old to set civil fines.

64. Kokesh, 137 S. Ct. at 1641.
65. Gabelli, at 448 (quoting from Rotella v. Wood, 528 U.S. 549, 555 (2000)).
66. Gabelli, at 448 (quoting from Railroad Telegraphers v. Railway Express Agency, Inc., 321 U.S. 342, 348-49 (1944)).
67. Witnesses lie and dissemble, documents typically do not.

Finally, limitations periods are designed to prevent unreasonable delay. In *Gabelli*, the Supreme Court explained that limitations periods exist because "even wrongdoers are entitled to assume that their sins may be forgotten."[68] Over time, offenders may have self-rehabilitated and could be prejudiced by the late-filed action.[69] Statutes of limitations promote certainty in legal affairs[70] and reduce "the danger of official punishment because of acts in the far-distant past."[71] But that is not what the five-year limitations period for SEC actions does. The SEC does not typically prosecute old violations. Few SEC enforcement actions are dismissed for being entirely outside the limitations period. Instead, in a vast majority of cases in which it applies, the limitations period means that liable wrongdoers pay reduced monetary penalties.

Extending the limitations period to ten years might raise the concern that the SEC would begin to prosecute stale claims, but existing enforcement practices moderate that risk considerably. The SEC Enforcement Manual urges staff to proceed quickly and to prioritize enforcement of ongoing violations.[72] Moreover, limited staff means that the SEC can prosecute only a minority of violations and is is unlikely to shift its focus to old violations. And if it did, congressional oversight and public scrutiny can control any theoretically-possible overreach.

If the limitations period is not extended, the SEC will adjust. It might expedite investigations,[73] perhaps after investigating cases less thoroughly than before *Kokesh*. That could harm potential defendants. An enforcement action can put a defendant's business under a dark cloud, so SEC's internal procedures require enforcement staff to convince different superiors, including their immediate bosses, the Director of Enforcement, then the division head, and then finally the politically-appointed Commissioners to file the enforcement action.[74] This is the most important, yet least appreciated, due process protection that defendants in public enforcement actions enjoy. If the limitations period is not extended, the SEC will rely more heavily on technology and analytics,[75] perhaps at the expense of prosecuting violations that are not amenable to computerized oversight.[76] The SEC's limited resources mean that it cannot be everywhere at all times, so *Kokesh* might push the agency to look for misconduct under the street light. That will benefit the most sophisticated players who ply their trade in dark pools, buy and sell opaque

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68. Gabelli, at 449 (quoting from Wilson v. Garcia, 471 U.S. 261, 271 (1985).

69. See Ochoa & Wistrich, *The Puzzling Purposes of Statutes of Limitation*, 28 PAC. L.J. 453, 464-66 (1997); Note, *The Statute of Limitations in Criminal Law: A Penetrable Barrier to Prosecution*, 102 YALE L.J. 630, 634 (1954).

70. Gabelli, 133 S.Ct. at 1221 (explaining that statutes of limitations provide "security and stability to human affairs" and are thus "vital to the welfare of society").

71. Toussie v. United States, 397 U.S. 112, 114-15 (1970).

72. *See* SEC. & EXCH. COMM'N, DIV. OF ENFORCEMENT, ENFORCEMENT MANUAL 13, 15 (2016).

73. *See* U.S. Sec. & Exch. Comm'n, Office of Inspector General, Memorandum, at 4 (Oct. 5, 2018), https://www.sec.gov/Inspector-Generals-Statement-on-the-SECs-Mgt-and-Performance-Challenges-Oct-2018.pdf (urging quick investigations, but not at the expense of quality).

74. In other words, the Division of Investment Management must sign off on any enforcement action against investment advisers and funds, and the Division of Corporation Finance must approve any enforcement action for accounting misrepresentations.

75. The SEC has already build predictive models and algorithms for accounting fraud, insider trading, and cherry picking by broker dealers. The 2018 budget allocates $45 million for additional information technology enhancements. *See* U.S. Sec. & Exch. Comm'n, Investor Protection, Capital Formation and Market Integrity Are Top Priorities in SEC Budget Request, Press Release 2018-14 (Feb. 12, 2018), https://www.sec.gov/news/ press-release/2018-14.

76. For most offering frauds, fraudulent securities are not registered or traded in public markets, so visibility is very low.

instruments, and occupy corrupt boardrooms, but also some of the most straight-forward frauds, those that prey on the least-sophisticated retail investors.

A. Statute of Limitations for Equitable Relief **(McAdams Discussion Draft)**

Representative McAdams' Discussion Draft authorizes the SEC to seek disgorgement, restitution, injunctions, and officer and director bars in court, and further defines all as equitable relief.[77] As such, it exempts equitable relief from the five-year statute of limitations and subjects it to a more flexible equitable limitations period of laches (i.e., unreasonable delay in the pursuit of legal claims).

Much of what I wrote in Part II.A applies here as well, but more forcefully. Doing nothing undermines capital markets and threatens retail investors. Charles Kokesh is not atypical of SEC defendants ordered to pay disgorgement. Kokesh "specifically targeted smaller investors (those investing $5,000 or less) because they would be less likely to sue if they discovered his schemes."[78] He funded an extravagant lifestyle with monies stolen from retail investors, "including by purchasing a gated mansion, buying and renovating a private polo ground, and keeping a personal stable of more than 50 horses."[79] The SEC moved diligently after Kokesh's fraud was first uncovered, and filed its enforcement action two years later. Because Kokesh was able to conceal his fraud for more than a decade, the five-year limitations period allowed him to keep the bulk of the money he stole from investors. Treating disgorgement and restitution as equitable relief would exempt them from section 2462 and allow the SEC to seek relief so long as it did not unreasonably delay prosecution.

Treating disgorgement, restitution, and bars as equitable relief does not enable the SEC to prosecute wrongdoers decades after their violations. Equitable defense of laches requires that the SEC proceeds with diligence in the pursuit of its claims, so that it does not delay enforcement unreasonably. The language in the Discussion Draft is modeled on section 6c of the Commodities Exchange Act, which authorizes the CFTC to seek equitable relief in actions filed in district court.[80] That provision was added in the Dodd-Frank Act in 2010 and has been used without controversy. Because the two agencies—the SEC and the CFTC—police similar misconduct in similar assets, similar sanctions are appropriate.

III. BAD ACTOR DISQUALIFICATIONS

In 2015, I published an academic study of a group of mandatory collateral consequences in securities laws called "bad-actor" and "ineligible-issuer" disqualifications.[81] Bad actor disqualifications are collateral consequences of civil and criminal securities enforcement actions; these bar individuals and firms sanctioned for serious securities violations from relying on relaxed disclosure and reporting requirements when raising external capital. Bad actors cannot raise funds

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77. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-sea34.pdf.

78. SEC v. Charles Kokesh, Memorandum Opinion and Order Granting Plaintiff's Motion for Entry of Final Judgment, at 9, No. 09-cv-1021 SVM/LAM (Mar. 30, 2015).

79. David J. Lynch, *Supreme Court Justices Question SEC Enforcement Tool*, FIN. TIMES (Apr. 18, 2017).

80. 7 U.S.C. § 6c(d)(3).

81. Urska Velikonja, *Waiving Disqualification: When Do Securities Violators Receive a Reprieve?*, 103 CAL. L. REV. 1081 (2015).

through private placements, for example.[82] Ineligible issuers cannot tap public markets using the automatic shelf registration statement but can continue to register securities on the shelf, which is only marginally slower.[83]

First enacted in 1940, the primary goal of bad actor disqualifications is to reduce the risk of future violations in the securities markets. Recidivism among securities violators is common, and a prior enforcement action is a solid predictor of future misconduct. The objective of disqualifications is to make unavailable relaxed provisions for selling securities that require less disclosure and oversight, and force disqualified issuers instead to sell securities by providing somewhat more substantial disclosure and subjecting them to greater SEC oversight. As such, bad actor disqualifications are prophylactic measures that protect investors and markets from high-risk issuers.[84]

We know that many securities defendants are likely to reoffend but we do not know which ones. Because of that, triggering events are intentionally overbroad, and the statutes authorize the SEC to waive bad actor disqualifications on showing of good cause. The Commission has delegated the task to the Division of Corporation Finance, which in turn has sub-delegated that authority to staff: the Chief of the Office of Small Business Policy waives bad actor disqualifications under Regulations A and D, and the Office of Enforcement Liaison waives ineligible-issuer disqualifications.[85] Each of the five Commissioners retains the right to request that the entire Commission vote on any waiver decision.

The waiver of a bad actor disqualification is appropriate when the defendant can show the SEC that the risk it will defraud investors again is sufficiently low to warrant a waiver. The good cause test is a multi-factor test that includes at least some considerations that are plausibly correlated with the risk of fraud in the disqualified offering.[86] The first is that an individual who committed securities fraud is unlikely to obtain a waiver of the disqualification. If an executive has been charged with fraud and that executive remains with the company, a waiver to the firm typically is not granted because the risk of repeat misconduct is substantial. Secondly, longer-lasting frauds, likewise, suggest a higher risk of recidivism. Thirdly, failure to take remedial steps also increases the risk of future violations. All these factors are considerations against granting a good-cause waiver from bad actor disqualifications.

The fourth and final factor for granting a good-cause waiver under the existing approach is unrelated to the recidivism risk but instead takes into account the impact on the issuer or third parties if the waiver is denied, and this is the most problematic rationale. It was added to avoid harm to innocent third parties and it includes situations where a waiver is clearly appropriate: disqualification under rule 506(d) of Regulation D will bar from private placements not only the firm or individual that was found liable in an SEC enforcement action, but also any company in which the disqualified firm or individual owns or controls 20 percent or more of the stock. As a result, disqualification of a private equity firm would also disqualify portfolio companies in which

82. 17 C.F.R. 230.506(d).
83. 17 C.F.R. 230.405.
84. *See id*. at 1101-02.
85. *See* Velikonja, *Waiving Disqualification*, *supra* note 81, at 1093 n.72.
86. *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.

that private equity firm owns a minority stake.[87] Portfolio companies typically operate independently and so their risk of committing fraud is unrelated to the fraud risk of their minority owner. In that case, disqualification of portfolio firms would harm third parties with no benefit to investors.

In my study referred to above, I reported that between July 2003 and December 2014, almost ***82 percent*** of all granted waivers were issued to large financial firms (i.e., subsidiaries of public firms that were registered broker-dealers or investment advisers and had more than 1,000 employees), a class that includes ***fewer than 4 percent*** of all defendants in SEC enforcement actions. Not only that, financial firms that were subsidiaries of public firms almost always received a waiver when disqualified. That discrepancy might be justifiable if those defendants posed a low risk of recidivism and/or their disqualification would produce substantial losses to innocent third parties.

The empirical evidence on the misconduct risk of large financial firms and their employees is quite mixed. Large firms are often named as defendants in SEC enforcement actions, but their size is just as likely the cause as is their propensity for fraud. The median advisory firm has 10 registered advisers, whereas the largest has more than 30,000.[88] If bad advisors are spread evenly through the population of advisors, then a large firm will have more of them even if the average employee is just as honest as the average advisor nationwide. For at least some firms, this does not appear to be true. In particular, some large financial firms are much more likely than others to hire "bad apples" fired by other firms[89], and engage in repeat misconduct.[90] If large financial firms are not low-risk because of their size, then the only justifiable reason for their different treatment as compared with other classes of defendants would be factors that mitigate the risk of securities fraud, such as closer SEC or other regulatory oversight, the imposition of an internal monitor, or improved self-policing.[91] But waiver orders are light on detail, so it is unclear how closely does the SEC staff scrutinize the existence of alternative risk-reduction measures.

SEC staff appears to treat large non-financial firms with kid gloves as well. When Tesla's CEO Elon Musk settled with the SEC in October 2018 for lying about a pending acquisition, and was enjoined from violating section 10(b) of the Securities Exchange Act, that settlement triggered bad actor disqualifications for the private placement exemption for Musk and Tesla, as well as for three private companies that Elon Musk controls: The Boring Company, Neuralink, and Space Exploration Technologies (SpaceX). SEC staff promptly issued waivers to Tesla and the three private companies, even though Musk controls them and remains high-risk for securities fraud. Waiver requests by all three private companies that Musk controls are very clear that the

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87. *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.

88. Fewer than 5 percent of registered investment advisers have more than 500 registered advisers. Mark Egan, Gregor Matvos & Amit Seru, *The Market for Financial Adviser Misconduct*, 127 J. POL. ECON. 233 (2019).

89. *See id.*; http://eganmatvosseru.com/index.php/firm-rankings/ (listing Oppenheimer, Wells Fargo, UBS, and Morgan Stanley among firms where more than 10 percent of registered advisers have a record of misconduct).

90. *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).

91. *See* Velikonja, *Waiving Disqualification*, *supra* note 81, at 1103-04.

companies have "not taken any remedial actions in response".[92] Tesla's waiver request lists as remedial steps only those actions that Tesla was required to take under the settlement with the SEC.[93]

An alternative explanation for the high rate of good-cause waivers granted to large financial firms is that although they may not present a low risk for recidivism, their disqualification would produce large third-party effects. But as I showed in my study, large firms requesting and receiving waivers are not innocent bystanders nor would their disqualification cause particularly harmful third-party effects. For example, Tesla argued that failure to receive a waiver from Regulation D would harm its shareholders. Tesla is a public company and has not issued securities to outside investors in a private placement since 2011.[94] Tesla's need for Regulation D exemption, at this point, is merely theoretical, and there are solid substitutes to the exemption that would allow Tesla to raise funds, albeit with more disclosure and more SEC oversight. Similarly, Jefferies, a brokerage firm fined by the SEC for defrauding the federal Troubled Asset Relief Program (TARP),[95] suggested in its request for a waiver that a bad actor disqualification would have "an adverse effect on third parties that have retained, or may retain" Jefferies in the future, and so it needed a waiver.[96] What Jefferies describes is not a third-party effect but rather a direct cost to Jefferies from losing future business. As long as the disqualified firm is not a monopolist in any market, competitors can and will step up to serve the disqualified firm's clients.

Nor would disqualifications typically amount to a "corporate death penalty"[97]—an analogy that is grossly exaggerated. Based on this exaggerated analogy, large financial firms routinely received waivers of the ineligible issuer disqualification before the financial crisis. In 2009, during the settlement process between the SEC and Bank of America related to proxy fraud in BofA's acquisition of Merrill Lynch, waivers became a sticking point. Bank of America insisted in July 2009 that it could not operate without a waiver from the ineligible issuer disqualification.[98] It refused to settle with the SEC unless it was assured of waivers. The SEC ultimately relented. But Bank of America exaggerated the harm if it was denied a waiver. The alternative to automatic shelf

92. https://www.sec.gov/divisions/corpfin/cf-noaction/2018/the-boring-company-101618-506d.pdf; https://www.sec.gov/divisions/corpfin/cf-noaction/2018/space-exploration-technologies-corp-101618-506d.pdf; https://www.sec.gov/divisions/corpfin/cf-noaction/2018/neuralink-101618-506d.pdf.

93. https://www.sec.gov/divisions/corpfin/cf-noaction/2018/tesla-inc-101618-506d.pdf.

94. In 2013, Tesla sold $55 millions of securities to Elon Musk under Regulation D. If that exemption were not available to Tesla at the time, it could have sold those same securities to Musk under the statutory private placement exemption. The net harm to Tesla from the disqualification would have been zero. *See id*.

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

96. 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 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.

97. Daniel M. Gallagher, Comm'r, SEC, Why Is the SEC Wavering on Waivers? Remarks at the 37th Annual Conference on Securities Regulation and Business Law, (Feb. 13, 2015), https://www.sec.gov/news/speech/021315-spc-cdmg.html.

98. 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 THE BANK OF AMERICA'S STATUS AS A TARP RECIPIENT 41 (2010) (quoting from Bank of America's request that a waiver denial "would be unduly and disproportionately severe" and would have "significant negative consequences on Bank of America and its shareholders").

registration—the securities offering rules that ineligible issuers are barred from using—is not bankruptcy but regular shelf registration, which requires only marginally more substantial oversight and entails only minimal delay. It should come as no surprise that Bank of America was not harmed when it was disqualified under the same provision in October 2014. Citigroup became an ineligible issuer in 2010 and again in 2014, and performed just fine during the three years that it was disqualified. (Both are among a handful of disqualified large financial firms that did not receive waivers.)

In other words, it appears that staff has continued to deny waivers to individuals and small firms because they pose a high risk of recidivism, but has continued to grant waivers from bad actor disqualifications to large public and financial firms not because they pose a low risk, but because they would otherwise refuse to settle with the SEC.

The Discussion Draft's proposals are an excellent way to return disqualifications to their intended objective—as prophylactic measures to reduce fraud risk. First, the Discussion Draft requires that the Commission, and not staff, make waiver determinations. Currently, staff make waiver determinations in an opaque process, so little is known about who receives a waiver and why, and whose waiver requests have been denied and why. Elevating the decision to the Commission would improve the transparency and predictability of the process. Second, the Discussion Draft requires a mandatory public hearing before the decision on any waiver. The hearing requirement clearly separates the Commission vote on the enforcement action from its vote on the bad actor disqualification waiver, and does so by delaying the vote on the waiver by as much as 180 days. By doing that, the proposal allows the Commission to focus on one question at a time: proper sanction for the violation at step one, and evaluating recidivism risk at step two. The Commission would no longer be susceptible to criticism that it is using disqualifications as leverage in enforcement action settlements, and waiver conversations would no longer overlap with settlement conversations. Third, the Discussion Draft includes clear language that bars consideration of "direct costs to the ineligible person" in deciding on whether to grant a waiver from bad actor disqualifications. If the objective is protecting investors and capital markets from bad actors, it is irrelevant whether the already-sanctioned firm would be harmed by the violation.