NSCP
THE NATIONAL SOCIETY OF COMPLIANCE PROFESSIONALS

JULY 2017 SPECIAL REPRINT

Currents

The Financial Choice Act of 2017: Impact on SEC Operations and Oversight

It's Not Just About the Banks: Expanded Oversight and Rights for Respondents

While much of the discussion about the potential impact of the Financial CHOICE Act of 2017 (the "Act") is focused on banks, the effect of the proposed reforms of the Act on the operation of the Securities and Exchange Commission ("SEC" or the "Commission") is no less fundamental. Whether or not one agrees with the approach outlined in the Act, it is important to understand what those proposed reforms are and what they could entail for SEC staff ("staff") and potential respondents in enforcement proceedings. In short, the proposed reforms would mean expanded rights for the subjects of SEC enforcement actions and additional constraints on SEC enforcement attorneys.

The legislation is purported to ensure that defendants are not denied due process as a result of certain actions the staff have been able to initiate in their "home court", i.e., the administrative proceeding framework. In addition, the Act imposes a series of reforms about the operations of the Commission itself, combined with providing new protections for targets of investigations and enforcement actions. For example, it has long been the case that there is limited information as to whether the staff is closing an investigation. The new Act will not only now require that the staff initiate a formalized and much more expedited process for closing cases, but also inform people when that investigation is closed. Section 817 of the Act requires the SEC "establish a process for closing investigations", formal or informal, "in a timely manner" and inform "persons who are the subject of the investigation that the investigation is closed."[1]

The Act also imposes greater regular scrutiny over the Commission itself. It requires the appointment of a separate enforcement "ombudsman" to provide oversight for the actions of Enforcement staff, as well as giving greater independence to the SEC's regular ombudsman by directing their reporting line to the SEC commissioners.[2]

Requirements for Transparency and Economic Impact

The Enforcement staff, in general, is required to submit to higher standards of transparency. As part of this effort, the staff is now required to "publish an updated manual that sets forth the policies and practices that the Commission will follow in the enforcement of the securities laws."[3] The Enforcement Manual must be "developed so as to ensure transparency in such enforcement and uniform application" of laws by the Commission.[4] As its own registrants must do, the SEC now must also maintain and update an Enforcement Manual. Apparently not content with the current practice of the Office of Compliance Inspection and Examination's ("OCIE") Annual Priorities Letter, the Act goes a step further in demanding notice and transparency by requiring an Annual Enforcement Plan. The SEC is required to "transmit to Congress and publish on its Internet website an annual enforcement plan" that will, among other things, detail the priorities of the Commission with regard to enforcement and examination activities for the upcoming year, "contain an analysis of litigated decisions not found in favor of the Commission over the preceding year", contain a description of emerging trends the Commission has focused on as part of its enforcement program and "provide an opportunity and mechanism for public comment."[5] Both the Enforcement Manual and the Annual Enforcement Plan thus impose continuing requirements on the Commission going forward.

The Comprehensive Summary of the Act ("Comprehensive Summary")[6] outlines Congress' additional concerns about some of the practices of the Commission's penalties vis-a-vis the economic impact on issuers. The Comprehensive Summary states, "even though the SEC is collecting larger penalties from public companies, those penalties may not be having the intended effect."[7] As such, the proposed legislation is designed to protect against the possibility that corporate employees who are engaged in malfeasance will simply continue to do so, because the SEC will impose penalties on the corporations rather than the individuals themselves. Accordingly the Comprehensive Summary has criticized the SEC's "penchant for imposing civil penalties on corporations" rather than "bringing enforcement actions against individual offenders."[8] In other words, the Act addresses the fear that the actions of bad actors will simply continue to perform bad acts because they have little to lose.

To address this problem and reduce the possibility of punishing the innocent shareholders, the SEC staff will now be required to produce "written findings", supported by both the Division of Economic and Risk Analysis and supported by the SEC Chief Economist that the alleged malfeasance actually resulted in "direct economic benefit" to the issuer and that the proposed SEC penalties "do not harm the issuer's shareholders."[9]

1. Financial CHOICE Act of 2017, H.R. 10, 115th Cong. § 817(a) (2017).

About the Authors

Don Andrews is a partner in Reed Smith LLP's Financial Industry Group and global practice leader of the firm's Risk and Compliance Group. He can be reached at dandrews@reedsmith.com

Bonnie Mangold is an associate in Reed Smith LLP's Financial Industry Group. She can be reached at bmangold@reedsmith.com

Reed Smith website: www.reedsmith.com/en/

2. See id. § 818(a)(i).
3. Id. § 822(a).4. Id.
5. Id. § 822(b).
6. The Financial CHOICE Act, A Republican Proposal to Reform the Financial Regulatory System, 1 (Apr. 24, 2017), Comprehensive Summary, https://financialservices.house.gov/choice/.
7. Comprehensive Summary, supra note 6, at 116.
8. Comprehensive Summary, supra note 6, at 116.
9. Comprehensive Summary, supra note 6, at 119.

The SEC Arsenal

1. Administrative Proceedings
A major tool in the arsenal of SEC enforcement staff, the administrative proceeding loses some of its appeal as a result of the proposed reforms. A respondent in such a proceeding now would have the right for an "immediate removal" to federal court.

The sponsors of the Act point to recent appellate court decisions, such as the Tenth Circuit ruling in *Bandimere v. U.S. Securities and Exchange Commission*[10] that found that use of administrative law judges ("ALJs") actually violates the Constitution, as a basis for allowing respondents to remove their matters to federal court.[11] The Comprehensive Summary alsocites a recent speech by the acting SEC Chairman in which he observed that the "Enforcement Division's avoidance of federal court has the appearance of the Commission looking to improve its chances by moving its cases to its in-house administrative system.'"[12] Consistent with this theme, the SEC would no longer be able to pursue "officer and director bars" in their administrative proceedings, but would instead be required to prove their burden in federal court.

2. Wells Notices
More rights are also afforded to respondents who find themselves recipients of "Wells notices."[13] A Wells notice provides notice to a potential respondent that the staff has made a preliminary determination to recommend the Commission bring an enforcement action against them. Under the Act, the individual or entity will now have the "right to make an in-person presentation before the Commission staff concerning such recommendation" and "be represented by counsel at such presentation."[14] This change seems also to be made for the reason of leveling the playing field, given that once the action is filed, it is certainly far more difficult to defend and more damaging from a reputational standpoint.

3. SEC Advisory Council
The Comprehensive Summary outlines a number of concerns about how the staff utilizes such weapons as "automatic disqualifications" of officers and the practice of "rule-making by enforcement."[15] In the case of automatic disqualifications, it is noted that "[t]hese disqualifications were never meant to be enforcement enhancements" and have resulted in a system "that conflates the disqualifications with the SEC's current remedial and punitive authorities."[16] In other words, these disqualifications were never supposed to be a "bargaining chip." The Act's sponsors, however, still conclude that the staff has sufficient power and resources to take actions against respondents deserving of penalties and fines. The Comprehensive Summary states that "[w]hen the actions of individuals, corporations, or other entities warrant putting them out of business to protect investors, the SEC has sufficient authority to do so."[17]

Concerns over all of these practices, which have developed over the years, as well as the growing practice of "rule-making by enforcement"[18] led the sponsors of the Act to conclude that "[t] hese issues and others related to the SEC's sprawling enforcement program" cannot all be resolved within the scope of the Financial CHOICE Act.[19]

As such, they have proposed the requirement of a separate advisory council that would be required to report to both the Commission and Congress on a regular basis. The Act requires that the SEC appoint an advisory committee within six months to "conduct an analysis of the policies and practices of theCommission relating to the enforcement of the securities laws" as well as to "make recommendations to the Commission regarding changes to policies and practices."[20] The newly formed advisory committee is required to submit a report to the Commission as well as "appropriate congressional committees[21] containing the results" of recommendations on an annual basis.

The Act's sponsors plainly state that "[i]t has been 45 years since the Wells Committee engaged in a holistic review of the SEC's enforcement program."[22] Therefore, this new requirement is designed to revitalize an "introspective" program and to "modernize the SEC's Enforcement program and policies."[23] In doing this, the SEC Chairman has convened a committee "with the same mission as the original Wells Committee",[24] to ensure that the Commission's enforcement program comports with its "mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation and our constitutional due process rights."[25]

Increased Powers

Under the Act, the SEC does actually have some increased powers, especially in the area of civil penalty authority as well as criminal sanctions. There are significant increases for first and second tier penalties, and the Act "nearly doubles the penalty amounts for third-tier offenses."[26] In other words, there are substantial increases in penalties for the most serious offenses for corporations and individuals. The Act also imposes treble damages for recidivist offenders, and it increases criminal penalties for insider trading and corruption matters.

Conclusion

Proponents of the reforms will likely see the Act as an attempt to level the playing field for targets of enforcement actions, while opponents will see the measures as weakening the effectiveness of the staff in bringing actions and needless micro-managing. The Dodd-Frank Act[27] had imposed that the SEC utilize a consulting group in an effort to "improve processes and create efficiencies." Although the SEC has continued to report and update Congress on its progress in implementing the recommendations of this consulting group, the Act now requires that the "SEC enact the remaining recommendations of the 2011 Report … [and] report to Congress if it lacks the authority to fully implement such recommendations."[28] As such, this hardly sounds like a discussion as to whether it is prudent to implement the recommendations, but more of a mandate.

The bill would likely be controversial in any year, but given the political climate it may even be more so nowadays. In any event, it is clear that many long-debated issues about the enforcement operations of the SEC are contained in this bill and will be debated in the months and years to come.

10. Bandimere v. Securities and Exchange Commission, 844 F.3d 1168, 1188 (10th Cir. 2016).
11. Id. The constitutionality of using ALJs has been challenged under the theory that as "inferior officers" carrying out their duties, the Constitution requires that they must be appointed by the president, a court or a department head in order to ensure their accountability. Id.12.Comprehensive Summary, supra note 6, at 116 (citing Remarks by Commissioner Michael S. Piwowar at the "SEC Speaks" Conference 2015: A Fair, Orderly, and Efficient SEC, (Feb. 20, 2015), available at http://www.sec.gov/news/speech/022015 spchcmsp.html#.VOtB0fnF8kg)).
13. A Wells notice is a letter that the SEC sends to people or firms when it is planning to bring an enforcement action against them, indicating that the SEC staff has determined that it may bring a civil action against a person or firm and providing that person or firm with the opportunity to give information as to why the enforcement action should not be brought.7. Comprehensive Summary, supra note 6, at 116.
14. H.R. 10 § 821(a).
15. Comprehensive Summary, supra note 6, at 117-18.
16. Comprehensive Summary, supra note 6, at 117-18.11. Id.
17. Comprehensive Summary, supra note 6, at 118.
18. Through the SEC imposing "undertakings" as part of settlement proceedings, the SEC has in effect given these "undertakings" the weight of rules that now need to be followed by other registrants, by putting registrants "on notice that similar activities, even if not inconsistent with current regulations, could result in SEC enforcement actions." See Comprehensive Summary, supra note 6, at 118.
19. Comprehensive Summary, supra note 6, at 118.
20. See H.R. 10 § 820(b). Among the various issues to be reviewed by the Advisory Committee is how the Commission's enforcement objectives may be more effective, and to review the "enforcement practices and procedures from the point of view of due process." Id. § 820(b)(1)(B)(ii).
21. The "appropriate congressional committees" includes the "Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate." Id. § 820(g)(1).
22. Comprehensive Summary, supra note 6, at 118.
23. Comprehensive Summary, supra note 6, at 118.
24. Comprehensive Summary, supra note 6, at 119.
25. Comprehensive Summary, supra note 6, at 119.
26. Comprehensive Summary, supra note 6, at 115. A "third tier" offense involves "fraud, deceit, manipulation, or deliberate disregard of a regulatory requirement; and … such act or omission directly or indirectly resulted in -- … substantial losses or created a significant risk of substantial losses to other persons; or … substantial pecuniary gain to the person who committed the act or omission." H.R. 10 § 211(a)(2)(A)(iii).
27. The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L. 111-203, H.R. 4173, 111th Cong. (2010).
28. See H.R. 10 § 806.