Know The Collateral Consequences Of Financial Reg Action

Law360, New York (October 22, 2014, 11:17 AM ET) -- Financial services firms facing enforcement proceedings at the hands of the U.S. Securities and Exchange Commission or any other financial industry regulator must consider disclosure obligations in the context of the various collateral consequences that may arise from such proceedings. Firms with subsidiaries or activities that fall under the scope of the Investment Advisers Act, the Investment Company Act, the Securities Exchange Act, the Financial Industry Regulatory Authority or the Commodity Exchange Act also must consider these issues.

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Disclosure Issues

A typical financial services firm is subject to a variety of disclosure requirements, many of which require the firm to report disciplinary actions. The obligation to report a disciplinary action is dependent upon the facts of the event, its materiality, the entities or personnel involved (including affiliates, senior officers, directors/trustees and registered representatives, among others), the stage of the investigation or action, the violations found or alleged, the sanction or discipline imposed or threatened (e.g., censure, fine, injunction, cease-and-desist order, suspension or bar), and the manner in which the specific disclosure document or requirement defines the disclosure obligation.

Although the analysis of the situation is very fact-specific and should be conducted on a case-by-case basis, it should include the following:

What corporate entities, subsidiaries or affiliates have potential disclosure requirements?

The basic scope of disclosure involving affiliated entities for advisers is different from the scope for broker-dealers. Form ADV (for advisers) only requires the reporting of disciplinary actions involving affiliates that it controls or that control it, but Form BD (for broker-dealers) also requires reporting disciplinary actions involving affiliates under common control.

Thus, for example, if an adviser and a broker-dealer are under the common control of a parent holding company, the adviser would not have to report on Form ADV disciplinary actions involving the broker-dealer, but the broker-dealer would have to report on Form BD disciplinary actions involving the adviser.

Form ADV Part 1 disclosure requirements apply to "advisory affiliates," which include (a) all of an adviser's officers, partners or directors (or any person performing similar functions); (b) all persons directly or indirectly controlling or controlled by the adviser (discussed above); and (c) all of the adviser's current employees (other than employees performing only clerical, administrative, support or similar functions).

Form ADV Part 2 disclosure requirements apply to the adviser and its "management persons," which include anyone with the power to exercise, directly or indirectly, a controlling influence over the adviser's management or policies, or to determine general investment advice given to clients.

Typically, the following are considered management persons: (a) the adviser's principal executive officers, such as the chief executive officer, chief financial officer, chief operations officer, chief legal officer and chief compliance officer; directors, general partners or trustees; and other individuals with similar status or performing similar functions; (b) members of the adviser's investment committee or group that determines general investment advice to be given to clients; and (c) if the adviser does not have an investment committee or group, the individuals who determine general investment advice provided to clients. Form ADV Part 2 disclosure requirements also apply to persons for whom a brochure supplement is prepared.

Form BD disclosure requirements apply to the broker-dealer and its "control affiliates," which include any individual or organization that (a) directly or indirectly controls, (b) is under common control with (as discussed above), or (c) is controlled by the broker-dealer. This includes any current employee except one performing only clerical, administrative, support or similar functions, or who, regardless of title, performs no executive duties or has no senior policy-making authority.

Do we have to disclose that an investigation has begun?

An investigation prior to receipt of any Wells notice from the regulator is not categorically required to be disclosed on an adviser's Form ADV, a broker-dealer's Form BD, a commodity pool operator's Form 7-R or a registered representative's Form U4 (Form 8-R for a principal or an associated person of a CPO). Advisers must consider, however, their fiduciary obligations to disclose any legal or disciplinary event that would be material to a client's or prospective client's evaluation of the adviser's advisory business or the integrity of its management, whether or not there is an express form-based disclosure requirement.

Do we have to disclose a Wells notice?

A Wells notice typically is a statement of an intention or "threat" to recommend the institution of a formal proceeding rather than the actual institution of a formal proceeding. Thus, it generally is not categorically required to be disclosed on an adviser's Form ADV (subject to the fiduciary considerations discussed above for advisers), a broker-dealer's Form BD, a CPO's Form 7-R or a CPO principal's or associated person's Form 8-R. A Wells notice directed at a registered representative, however, is required to be disclosed on that registered representative's Form U4 (or Form U5, if terminated).

A Wells notice may be discloseable (a) pursuant to the registration forms for the offer and sale of securities, either of the firm itself or its sponsored products, because of form-based requirements or general materiality standards applicable to an offer and sale of securities; (b) either under general materiality standards applicable to proxy statements or form-based proxy statement disclosure requirements, for proxy statements of the firm itself or its sponsored products; or (c) to clients or others pursuant to contractual requirements or the terms of a request for proposal.

Although the question of whether to disclose a Wells notice in these areas requires a very fact-specific analysis and should be conducted on a case-by-case basis, examples of factors firms should consider include (a) the allegations set forth in the notice; (b) the potential consequences of an enforcement action or a settlement arising out of the allegations set forth in the notice; (c) the seniority and duties of any firm personnel named in the notice or receiving concurrent Wells notices arising out of the same facts; (d) the subject matter of any proposal submitted to shareholders via a proxy solicitation; (e) headline risk to the firm as it relates to clients and counterparties; and (f) the materiality of the potential disclosure to the transaction at hand.

Although a Wells notice on its own generally is not considered an automatic trigger for disclosure in a press release or a current report on Form 8-K, it may nonetheless be an appropriate topic to disclose depending on the content of the firm's existing public disclosures, the subject matter of the notice and the expectation for future disclosures. Note also that once an issuer files an 8-K regarding a Wells notice, it is typical to continue to disclose and update in future periodic reports.

Do we have to disclose a formal institution or final disposition of a proceeding?

Enforcement actions often are instituted and settled at the same time. However, in some cases a settlement cannot be reached and an action will be instituted and remain pending until brought to resolution through, most commonly, a judgment or settlement. This can be the case with both administrative actions and civil actions.

Actions that are pending, or that have been settled or determined adversely, generally are required to be disclosed on an adviser's Form ADV (including Part 2 with respect to completed proceedings determined adversely), a broker-dealer's Form BD, a CPO's Form 7-R or a registered representative's Form U4 (Form 8-R for a principal or an associated person of a CPO).

Actions that are pending, or that have been settled or determined adversely, also may be discloseable (a) pursuant to the registration forms for the offer and sale of securities, either of the firm itself or its sponsored products, because of express form-based requirements or general materiality standards applicable to an offer and sale of securities; (b) either under general materiality standards applicable to proxy statements or form-based proxy statement disclosure requirements, for proxy statements of the firm itself or its sponsored products; (c) in a press release or on a current report on Form 8-K; (d) to clients or others pursuant to contractual requirements or the terms of a request for proposal; and (e) pursuant to the rulebooks of swap execution facilities in which the firm participates.

Although the question of whether to disclose a pending action or completed proceeding that is settled or determined adversely in these areas is a very fact-specific analysis and should be conducted on a case-by-case basis, the same general types of considerations discussed above in the context of disclosing a Wells notice are instructive here. In general, pending actions or completed proceedings will involve less uncertainty than a Wells notice because facts will be more well-established, form-based disclosure requirements should be clearer and materiality should be easier to judge.

Actions that are pending or that have been settled or determined adversely generally are reportable to FINRA.

What are the collateral consequences and disabilities that we may be subject to as a result of an enforcement proceeding?

A typical financial services firm also is subject to a variety of laws that may automatically impose, or permit a regulator to impose, various disabilities as a result of a disciplinary event. The particular disabilities to which a firm may be subject is dependent upon, among other things, the facts of the event, the entities or personnel involved (including affiliates, senior officers, directors/trustees and registered representatives), the specific findings made in connection with the resolution of the event (i.e., in the settlement or court order), whether such findings involve violation of an anti-fraud statute or rule and whether such findings involve "willfulness," the sanctions imposed (e.g., fine, injunction, cease-and-desist order, censure, suspension or bar) and the particular statutory regime the disciplinary event triggers.

In some instances, these disabilities are automatically executing. In other instances, these disabilities require affirmative action by a regulator. Often, the concern is that an action by one regulator may provide a basis for another regulator to assert its independent disciplinary or enforcement authority, or that a regulator will "pile on" additional sanctions arising from a settled or decided action. Although this too is a very fact-specific analysis and should be conducted on a case-by-case basis, financial services firms should consider the applicability of the following:

If the SEC were to obtain an injunction against an investment adviser in connection with securities industry activity, Section 9(a) of the Investment Company Act would bar that adviser from serving as an adviser to a registered investment company absent an SEC exemptive order. Section 9(a) of the Investment Company Act is particularly broad in that the injunction against the adviser also would prohibit a broker-dealer affiliated with a barred adviser from serving as a principal underwriter to a registered investment company without an SEC exemptive order.

Similarly, injunctions against individuals would prohibit the adviser or the broker-dealer from employing those individuals while serving as an investment adviser to, or a principal underwriter for, a registered investment company without an SEC exemptive order, regardless of whether the individual was involved with the work performed for the registered investment company.

Article III of FINRA's bylaws contains a similar automatic bar, referred to as "statutory disqualification." This disability can be triggered by a broad set of disciplinary events, including both civil and administrative actions. These actions include not only injunctions in connection with securities industry activities but also administrative findings that a person (a) "willfully"[1] violated the federal securities or commodities laws; (b) "willfully" aided, abetted, counseled, commanded, induced or procured such violations; or (c) failed to supervise another who committed violations of such laws or rules.

It is notable that even though an SEC administrative action may not prevent an investment adviser from employing a particular individual if that individual is "dual-hatted" with an affiliated broker-dealer, the adviser may be prohibited from associating with the broker-dealer. FINRA has a process for persons subject to statutory disqualification to seek continued eligibility.

Section 9(b) of the Investment Company Act permits the SEC to impose discretionary sanctions on the employees, officers, directors, investment advisers and principal underwriters of registered investment companies upon a finding of (a) a "willful" violation of the federal securities or commodities laws or (b) "willfully" causing a materially false or misleading statement to be included in a document filed under the Investment Company Act. Sanctions include conditional or unconditional prohibitions on serving or acting in the above capacities for a registered investment company, as well as prohibition on serving or acting as an affiliated person[2] of an investment adviser or principal underwriter to a registered investment company.

Sections 203(e) and 203(f) of the Advisers Act and Sections 15(b)(4) and 15(b)(6) of the Securities Exchange Act collectively permit the SEC to impose discretionary sanctions on investment advisers, broker-dealers and their personnel. The authority to impose such sanctions arises if an adviser, broker-dealer or such personnel are subject to an injunction in connection with securities industry activity. This authority also arises if the adviser, broker-dealer or personnel has, among other things, been found to have (a) "willfully" violated the federal securities or commodities laws; (b) "willfully" aided, abetted, counseled, commanded, induced or procured such violations; or (c) failed to supervise another who committed violations of such laws or rules.

Importantly, Section 203(e) of the Advisers Act and Section 15(b)(4) of the Securities Exchange Act permit the SEC to sanction the adviser or broker-dealer as a result of the actions of its personnel, even if the disciplinary event happened prior to the person becoming associated with the adviser or the broker-dealer. These sanctions can include censures, limitations on activities, suspensions and revocations of registration. Additionally, Section 8a of the Commodity Exchange Act provides the CFTC with similar authority.

The Cash Solicitation Rule under the Advisers Act — Rule 206(4)-3 — prohibits persons subject to various disqualifications from soliciting advisory clients for compensation for a registered investment adviser. These disqualifications include being subject to an SEC order issued under Section 203(f) of the Advisers Act or being subject to any one of several disqualifications under Section 203(e) of the Advisers Act (though not all actions addressed in Section 203(e) of the Advisers Act are disqualifying for purposes of the Cash Solicitation Rule).

Under certain conditions, an otherwise disqualified solicitor can rely on standing no-action relief from the SEC staff to continue to act as a paid solicitor for a registered investment adviser.[3] One condition of this relief includes written disclosure, by the solicitor or the adviser, of the disciplinary action to solicited persons for 10 years from the date of the action.

Rule 506(d) under the Securities Act prohibits an issuer from utilizing the safe harbor for private placements afforded by Rule 506 if it is a "bad actor" or a "bad actor" is participating in the offering or is related to the issuer in certain designated capacities. "Bad actor"-designation events include injunctions in connection with securities industry activities, certain SEC administrative orders entered under Section 15(b) of the Securities Exchange Act or Sections 203(e) or 203(f) of the Advisers Act, and SEC cease-and-desist orders based on any scienter-based anti-fraud provision of the federal securities laws.

It is notable that SEC administrative orders that "place ... limitations on the activities, functions or operations" of a firm are considered "bad actor"-designating events. While seemingly directed at more serious sanctions on its face, the SEC staff has taken the view that this disqualification would apply to a relatively innocuous undertaking to engage a consultant to review, for example, a firm's compliance policies as a condition of a settled action. Firms should be aware of the broad reading the SEC staff takes of these "bad actor"-designating conditions and understand their implications. Rule 506(d) permits the SEC to waive this disqualification.

Issuers prohibited from engaging in certain conduct in violation of the securities laws as a result of an injunction or a cease-and-desist order are not permitted to utilize certain rules under the Securities Act designed to streamline the securities offering process for issuers who qualify as "well-known seasoned issuers," or WKSIs. Many of these rules concerning communications and registration processes apply only to WKSIs — generally characterized by the SEC as the most widely followed issuers in the marketplace. These rules are available for certain large and established issuers, which also are permitted to utilize additional types of communication before or at the time of such offerings, and more liberal means to deliver information to investors in connection with such offerings.

Specifically, these rules are unavailable to issuers that, during the prior three years, have violated the anti-fraud provisions of the federal securities laws or have been the subject of a judicial or administrative decree or order (including a settled claim or order) prohibiting certain conduct or activities regarding the anti-fraud provisions of the federal securities laws. Such issuers are defined as "ineligible issuers" under Rule 405 of the Securities Act, which are excluded from WKSI status. The SEC has discretion to waive an issuer's ineligibility.

The safe harbor under the Private Securities Litigation Reform Act of 1995 for certain forward-looking statements is not available to issuers that are the subject of a judicial order or administrative decree by the SEC that "prohibits future violations of the anti-fraud provisions of the securities laws" or "requires the issuer to cease and desist from violating the anti-fraud provisions of the securities laws." The SEC has the discretion to grant an order exempting the issuer from the loss of the statutory safe harbor.

What are the implications under my insurance policies, the indemnification terms of my governing documents and other material contracts?

When investigations conclude or are threatened, financial services firms also should consider the applicable terms and conditions of their various liability insurance policies, including notice requirements, and whether, and under what circumstances, insurance may pay for fines, legal costs or other significant expenses associated with a regulatory investigation or enforcement action.

Additionally, to the extent individual employees are the subject of an investigation or regulatory enforcement action, firms should consider to what extent the indemnification provisions of their governing documents, employment agreements or other agreements with such employees would permit or require the firm to pay the employees' legal costs and fees, including those in advance of the final disposition of the matter.

Firms also should review the representations and covenants in their contracts, particularly with clients and lenders, preferred stockholders, liquidity providers and other important counterparties, since disciplinary actions could implicate such representations and covenants.

Further, investment advisory and investment management contracts often require notice to clients of any regulatory subpoena, request for information or other investigation. Additionally, disciplinary actions could negate a noncompete provision in an employment contract or accelerate vesting provisions. Moreover, firms also should conduct a careful analysis of the implications of the disclosure and collateral consequences of disciplinary actions in the case of "sister" regulated subsidiaries — such as "sister" registered investment advisers — with overlapping personnel.

If financial firms find themselves the subject of an investigation by a financial industry regulator or an enforcement action, it is important for them to understand the possible collateral consequences of the various possible outcomes. Understanding these consequences can provide a valuable tool for proactively negotiating with the regulator, making informed decisions about the conduct, course and outcome of the investigation and avoiding additional pitfalls arising from a failure to disclose or appreciate the consequences of a regulatory enforcement action.

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[1] Note that the threshold for a finding of “willfulness” under the federal securities laws is low and does not require scienter.

[2] Under Section 2(a)(3) of the Investment Company Act, an “affiliated person” includes anyone controlling, controlled by, or under common control with, the subject firm; employees, officers and directors of the subject firm; anyone owning, controlling or holding with power to vote 5 percent or more of the subject firm’s voting securities; and anyone 5 percent or more of whose voting securities the subject firm owns, controls or holds with power to vote.

[3] Dougherty & Company LLC, SEC No-Action Letter (July 3, 2003).