Client Update
Financial CHOICE Act 2.0: Implications for the SEC and Capital Markets

NEW YORK
Mary Jo White
mjwhite@debevoise.com

Andrew J. Ceresney
aceresney@debevoise.com

Paul M. Rodel
pmrodel@debevoise.com

Brandon S. Finz
bfinz@debevoise.com

WASHINGTON, D.C.
Julie M. Riewe
jriewe@debevoise.com

Jonathan R. Tuttle
jrtuttle@debevoise.com

Renee M. Tierney
rmtierne@debevoise.com

Mark D. Flinn
mflinn@debevoise.com

On April 26, 2017, the Financial Services Committee of the U.S. House of Representatives will hold a hearing to discuss an amended and updated version of the Financial CHOICE Act ("CHOICE Act 2.0"), a bill sponsored by Rep. Jeb Hensarling that, if enacted, would repeal or modify several key provisions of the Dodd-Frank Act. In this client update, we review the changes that directly impact the U.S. Securities and Exchange Commission (the "SEC" or "Commission") and discuss key capital raising and ongoing SEC reporting changes that are new in CHOICE Act 2.0.

BACKGROUND

The House Financial Services Committee approved the first version of the Financial CHOICE Act in September 2016. As we summarized in a previous Client Update,[1] the legislation would repeal the SEC's private equity fund adviser registration and reporting requirements under the Investment Advisers Act and instead require these advisers to maintain records and provide to the SEC annual or other reports as the SEC determines by rule. It would also repeal a number of controversial disclosure requirements, such as pay-ratio disclosure — which went into effect this year — and conflict minerals reporting. In addition to increasing the SEC's penalty authority in civil actions and administrative proceedings, the proposed legislation would also repeal the SEC's ability to bar individuals from serving as officers and directors through administrative proceedings and permit SEC respondents to remove cases from administrative proceedings into federal court. The CHOICE Act would also eliminate automatic disqualification from certain privileges such as registration exemptions and expedited securities offerings, and require the Commission to determine, before imposing civil penalties against an issuer, whether the issuer directly benefitted

[1] Debevoise & Plimpton LLP, *Client Update: The Outlook for Financial Regulatory Reform Under President Trump* (Nov. 30, 2016), http://www.debevoise.com/insights/publications/2016/11/the-outlook-for-financial-regulatory-reform.

from the alleged violation and whether the penalty would harm the issuer's shareholders. Lastly, the CHOICE Act would expand eligibility for use of Form S-3, reduce oversight in connection with Regulation D offerings, modify the definition of "accredited investor," and reinstate Securities Act Rule 436(g), which was previously repealed by the Dodd-Frank Act.

While these and many other provisions remain unchanged in CHOICE Act 2.0, the revised bill contains key modifications and a handful of entirely new provisions discussed in detail below.

CHOICE ACT 2.0 – WHAT'S NEW?

SEC Enforcement Authority. CHOICE Act 2.0 includes several new provisions that would reform SEC enforcement authority, place limits on SEC whistleblower awards, and further enhance requirements for SEC reporting to Congress on enforcement activities. Specifically, if passed, CHOICE Act 2.0 would:

- Prohibit "co-conspirators" from receiving whistleblower awards. The proposed provision targets individuals who are "responsible for, or complicit in" the violation about which they provided information to the SEC, including any person that causes, aids or abets, or fails to fulfill his or her duty to prevent the violation. This provision would be unlikely to impact most whistleblower awards as only 2 of the 43 awards so far involved co-conspirators.
- Establish an advisory committee (Wells Committee 2.0) to evaluate the Commission's enforcement policies and practices and report recommendations within one year. The advisory committee would specifically be required to consider, among other things, the effectiveness of the SEC's enforcement policies and practices, their relationship to due process, the appropriate blend of regulation, publicity, and formal enforcement action, the criteria for selection and disposition of enforcement actions, and the suitability and effectiveness of sanctions imposed by the Commission.
- Require enforcement coordination among financial regulators — including the SEC — by directing financial regulatory agencies to implement policies and procedures to (1) minimize duplication between federal and state authorities when bringing enforcement actions; (2) determine when joint investigations and enforcement actions are appropriate; and (3) establish a lead agency in all joint investigations and enforcement actions.

- Prohibit "rulemaking by enforcement" by preventing the SEC from bringing an enforcement action if the subject of the action did not have adequate notice of the law, rule or regulation in a Commission-approved statement or guidance. In this respect, CHOICE Act 2.0 modifies and strengthens a provision in the original bill that would have required the SEC to establish a process to ensure that administrative and judicial actions brought by the agency are within its authority. Of course, it is somewhat unclear how this provision would ultimately be enforced, but it would provide an additional potential defense in certain actions.
- Expand on a requirement in the original bill that the SEC report annually to Congress on enforcement and examination priorities (both of which would be subject to public notice and comment requirements) to further require that the report include a description of emerging trends and describe novel legal theories or standards employed by the Commission.

Rulemaking Authority and Process. Like the original bill, CHOICE Act 2.0 would statutorily repeal the *Chevron* doctrine of judicial deference to interpretations by the SEC and other federal financial regulatory agencies. CHOICE Act 2.0 would make the repeal effective two years after enactment, whereas the original bill would have made the repeal effective immediately. The repeal of *Chevron* would obviously be significant and could call into question a number of SEC rule interpretations to date.

Choice Act 2.0 would also require the SEC to obtain a subpoena to compel the production of algorithmic trading source code or other similar intellectual property. This is consistent with amendments proposed by Rep. Sean Duffy to the Commodity End-User Relief Act imposing the same requirement on the U.S. Commodity Futures Trading Commission ("CFTC"). The CFTC recently proposed rules amending Regulation AT that would permit the agency to compel such data by vote of the Commission. The new provision in Choice Act 2.0 is largely a prophylactic measure to guard against the chance that other governmental agencies could follow suit.

Capital Raising. In addition to the limitations and guidelines on SEC enforcement and rulemaking authority, CHOICE Act 2.0 includes various substantive rule changes that were not in the original bill.

- Certain flexibility introduced by the JOBS Act would be expanded beyond emerging growth companies. Choice Act 2.0 would permit all initial public offering ("IPO") issuers to "test the waters" (i.e., engage in oral or written communications with institutions that are accredited investors or qualified

institutional buyers prior to an IPO) and submit draft registration statements for confidential review by the SEC.

- The resale exemption from registration under Securities Act Section 4(a)(7), introduced by the FAST Act in 2015, would be substantially broadened. Transactions involving general solicitation would not be considered a public offering or a distribution for purposes of Securities Act Section 2(a)(11), so long as each purchaser was an accredited investor and the sale of securities was made through a platform available only to accredited investors. Other existing limitations in existing Section 4(a)(7) (such as the information requirement, the business requirement and the bad actor prohibition) would be eliminated, and securities acquired under the revised Section 4(a)(7) would no longer be deemed restricted securities or to have been acquired in a private transaction. The Section 4(a)(7) exemption would nonetheless continue to be unavailable for transactions where the seller was the issuer (or a subsidiary or parent), an underwriter acting on behalf of the issuer (or a subsidiary or parent) who receives compensation with respect to such sale, or a dealer.
- Although the Securities Act definition of accredited investor would be modified, any person who, by reason of their net worth or income, is an accredited investor prior to the date of enactment will remain an accredited investor going forward.
- Federal law would exempt a loan from state usury laws if the loan was originated in another state and was not usurious when made.
- As amended, CHOICE Act 2.0 would establish a streamlined process for new products, such as ETFs, to obtain exemptive relief under the Investment Company Act.

Ongoing Reporting Requirements. CHOICE Act 2.0 additionally contains new substantive disclosure requirements for issuers, including:

- Revisions to Section 12(g) of the Exchange Act that would require registration only for issuers with $10 million of total assets and 2,000 or more holders of record. The SEC would have authority to raise the record holder threshold and the asset threshold would be indexed to inflation every five years. Additionally, SEC registration could be terminated once an issuer has fewer than 1,200 holders of record.
    - Currently, the registration requirement applies to issuers with $10 million of total assets and 500 non-accredited investor holders of record.

  - Currently, an issuer must have fewer than 300 holders of record to be eligible for deregistration.

- The threshold for the Sarbanes-Oxley 404(b) requirement for auditor attestation of issuer internal control over financial reporting would be increased from $75 million to $500 million public float or, in the case of depositary institutions, at least $1 billion in assets.
- Shareholder proposal and resubmission thresholds would be updated to tighten proposal eligibility. Currently, any shareholder who owns $2,000 worth of a company's stock for one year may require the company to include one shareholder proposal in the company's proxy statement sent to all shareholders. Proposed changes include:
  - Shareholders must own at least one percent of the company over a three-year period prior to submitting a shareholder proposal.
  - Required thresholds to resubmit a shareholder proposal would be at least doubled.
  - Prohibition on shareholder proposals submitted by proxies acting on behalf of other shareholders.
- The additional disclosure threshold required for securities offerings pursuant to compensatory benefit plans under Rule 701 would be increased from $5 million to $20 million. This would amend legislation previously introduced in the 113th Congress, which proposed a $10 million threshold.
- The SEC would be prohibited from promulgating a universal proxy ballot requirement. In October 2016, the SEC proposed universal proxy ballot requirements that would mandate the use of universal proxy cards in all contested director elections.

WHAT TO EXPECT AFTER THE HOUSE FINANCIAL SERVICES COMMITTEE HEARING

Depending on the outcome of the House Financial Services Committee hearing this week, CHOICE Act 2.0 could be introduced in the House later this spring. While there is bipartisan support for financial regulation reform, the Democrats and Republicans disagree over changes to certain provisions of the Dodd-Frank Act. There appears to be sufficient support by the Republican majority to pass the bill in the House, but CHOICE Act 2.0's fate in the Senate is less certain given Democratic opposition. The question is whether the bill is a sufficiently high priority to get beyond the House given other priorities, including tax reform, health care, infrastructure, and budget issues, and what portions of the

bill would survive the inevitable negotiations and back and forth that would follow any House adoption.

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As the proposed legislation moves through Congress, we will continue to monitor potential ramifications from legislative and regulatory developments related to CHOICE Act 2.0.