Client Alert

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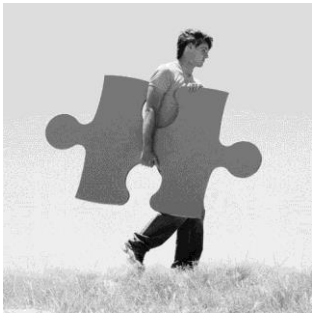

The Financial Choice Act: Implications for the U.S. Securities Legal Framework

On September 13, 2016, the House Financial Services Committee of the United States House of Representatives (the "FSC")[1] formally released H.R. 5983, the "Financial CHOICE Act" (the "CHOICE Act").[2] While the CHOICE Act has largely been viewed through a financial regulatory lens, as the first major concerted effort to provide an alternative to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") as a way to end "Too Big to Fail," the CHOICE Act, as currently drafted, would also repeal a number of the specialized disclosure provisions that were contained in the Dodd-Frank Act and subsume "JOBS Act 2.0" capital formation measures that have largely been presented to date as standalone bills.

This alert provides an overview of the sections of the CHOICE Act that would impact U.S. securities laws, which are contained in Title IV and Title X of the CHOICE Act.

I. REFORMS TO TITLE IX OF THE DODD-FRANK ACT

Title IX of the Dodd-Frank Act set forth certain initiatives intended to improve investor protection; securities disclosures related to, among other things, executive compensation and asset-backed securities; and securities enforcement. The CHOICE Act proposes certain amendments to Title IX that the FSC believes will eliminate provisions that restrict financial opportunity and investment options for investors.

Fiduciary Duty Rule. The CHOICE Act would require the SEC, before promulgating a heightened standard of conduct for broker-dealers, to report to the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs on whether:

- retail customers are being harmed because broker-dealers are held to a different standard of conduct from that of investment advisers;
- alternative remedies will reduce any confusion and harm to retail investors due to the different standard of conduct;
- adoption of a uniform fiduciary standard would adversely impact the commissions of broker-dealers or the availability of certain financial products and transactions; and
- the adoption of a uniform fiduciary standard would adversely impact retail investors' access to personalized and cost-effective investment advice or recommendations about securities.

Asset-Backed Securities and Credit Rating Agencies. The CHOICE Act would eliminate the risk retention requirements for asset-backed securities other than residential mortgages, which currently require financial

[1] The FSC oversees the financial services industry, including the securities, insurance, banking, and housing industries.
[2] *See* Financial CHOICE Act, H.R. 5983 114th Cong. (Sept. 13, 2016), *available at*: https://www.congress.gov/114/bills/hr5983/BILLS-114hr5983ih.pdf.

institutions to retain a certain minimum position in such deals. The proposal would also seek to repeal the Franken Amendment, which, if implemented pursuant to Section 939F of the Dodd-Frank Act, would largely unwind Section 939A of the Dodd-Frank Act. Section 939A sought to have agencies remove references to credit ratings from all statutes, regulations, and rulebooks and instead instructed such agencies to establish standards of credit-worthiness that were appropriate for the purposes of the regulations.

Relief for Smaller Issuers. Section 989G of the Dodd-Frank Act made permanent the exemption for non-accelerated filers to comply with an outside auditor's attestation of a company's internal financial controls mandated by Section 404(b) of the Sarbanes-Oxley Act. The threshold for complying with Section 404(b) is a $75 million market capitalization. The CHOICE Act increases the exemption to issuers with a market capitalization of up to $250 million and extends the exemption to depository institutions with less than $1 billion in assets.

Executive Compensation, Incentive-Based Compensation, and Pay Ratio Disclosure. Title IX of the Dodd-Frank Act expanded executive compensation and incentive-based compensation disclosure. Under Section 956 of the Dodd-Frank Act, federal banking agencies, the SEC, the Federal Housing Finance Agency (the "FHFA"), and the National Credit Union Administration (the "NCUA") are required to issue new rules to prohibit incentive-based compensation structures that encourage inappropriate risks at financial institutions with greater than $1 billion in assets. Section 953(b) of the Dodd-Frank Act requires all publicly-traded companies, except for emerging growth companies ("EGCs"), to calculate and disclose certain SEC filings, the median annual total compensation of all employees, excluding the Chief Executive Officer (the "CEO"), the annual total compensation of the CEO; and calculate and disclose a ratio comparing those two numbers. The CHOICE Act would seek to repeal any of the Dodd-Frank Act provisions relating to incentive-based compensation and pay ratio disclosures.

II. REFORMS TO CAPITAL FORMATION

Title X of the CHOICE Act includes many provisions to facilitate capital formation.[3]

Simplification of Small Business Mergers, Acquisitions, Sales, and Brokerage. Section 1001 of the CHOICE Act would provide a registration exemption through an amendment to Section 15(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which would exempt an "M&A broker" from registration under the Exchange Act, subject to certain excluded activities and disqualifications. This exemption is consistent with the guidance in the SEC Staff's no-action letter issued in 2014.[4]

Encouraging Employee Ownership. Section 1006 of the CHOICE Act would increase the threshold for disclosures relating to compensatory benefit plans. Specifically, no later than 60 days after the date of the enactment of the CHOICE Act, the SEC would be required to revise Rule 701 ("Rule 701") under the Securities Act of 1933, as amended (the "Securities Act"), so as to increase from $5 million to $10 million the aggregate sales price or amount of securities sold during any consecutive 12-month period in excess of which the issuer is required to deliver an additional disclosure to investors.[5]

Simplification of Small Company Disclosure Requirements. The CHOICE Act would provide an exemption for emerging growth companies ("EGCs") and certain other smaller companies from Extensible Business Reporting Language ("XBRL") requirements. Specifically, EGCs and issuers with less than $25 billion in total annual gross revenues would be exempt from the XBRL requirements for financial statements and other periodic reporting required to be filed with the SEC. However, both EGCs and qualifying smaller issuers may elect to still use XBRL for such reporting. The XBRL exemption for qualifying smaller issuers would continue to be in effect until either

[3] *See* CHOICE Act, at Title X, Subtitles A-Q.
[4] *See M&A Brokers*, SEC No-Action Letter (Feb. 4, 2014), *available at*: https://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf.
[5] Similar provisions are contained in the Encouraging Employee Ownership Act, which has been passed by the U.S. House of Representatives. *See* H.R. 1675 114th Cong. (2015-2016), *available at*: http://docs.house.gov/billsthisweek/20160201/CPRT-114-HPRT-RU00-HR1675.pdf.

(i) five years after the date of the enactment of the CHOICE Act, or (ii) the date that is two years after a determination by the SEC that benefits of such requirements to such issuers outweigh the costs, but no earlier than three years after the enactment of the CHOICE Act.[6]

SEC Overpayment Credit. The CHOICE Act would provide a mechanism for the refunding or crediting of overpayment of fees paid in connection with Section 31 of the Exchange Act ("Section 31"), or "transaction fees." Section 31 would be amended in such a way so that if a national securities exchange or national securities association pays to the SEC an amount that exceeds the fees and assessments due under Section 31 and informs the SEC of such an excessive payment within 10 years of the date of the payment, the SEC will offset future fees and assessments due by such exchange or association in an amount equal to such excess amount.

Fair Access to Investment Research. The CHOICE Act would expand the safe harbor for investment fund research provided by Rule 139 under the Securities Act ("Rule 139"). Under the CHOICE Act, the SEC would be required to adopt revisions to Rule 139 to provide that a covered investment fund research report that is published or distributed by a broker-dealer: (i) does not constitute an offer for sale or an offer to sell a security that is the subject of an offering pursuant to a registration statement that is effective, even where the broker-dealer is participating (or will participate) in the registered offering of the covered investment fund's securities; and (ii) satisfies the conditions of Rule 139(a)(1) and Rule 139(a)(2) and the rules of any SRO. Pursuant to Section 1021 of the CHOICE Act, a "covered investment fund research report" would include research reports published or distributed by a broker-dealer about a "covered investment fund" or any securities issued by the covered investment fund, but not including research reports to the extent that they are published or distributed by the covered investment fund itself or any affiliate of the covered investment.

Accelerating Access to Capital. Section 1026 of the CHOICE Act would expand the eligibility for use of a registration statement on Form S-3. Under the CHOICE Act, the SEC would be required to revise Form S-3 in order to:

- permit securities to be registered pursuant to General Instruction I.B.1. of Form S-3 (*Primary Offerings by Certain Registrants*), provided that either:
    - the aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant is $75 billion or more; or
    - the registrant has at least one class of common equity securities listed and registered on a national securities exchange; and
- remove the requirement of paragraph (c) from General Instruction I.B.6. of Form S-3 (*Limited Primary Offerings by Certain Other Registrants*).

Establishment of an SEC Small Business Advocate. Section 1031 of the CHOICE Act would amend Section 4 of the Exchange Act by establishing within the SEC an "Office of the Advocate for Small Business Capital Formation." To serve as the head of the Office of the Advocate for Small Business Capital Formation (the "Advocate"), such a person must:

- maintain prior experience in advocating for the interests of small businesses and encouraging small business capital formation; and
- not currently be employed by the SEC.

The Advocate would be required to conduct the following functions, among others:

- assist small business and small business investors in resolving significant problems such business and investors may have with the SEC or with SROs;

[6] This provision of the CHOICE Act mirrors the Encouraging Small Company Disclosure Simplification Act, which has passed the U.S. House of Representatives. *See* H.R. 1965 114th Cong. (2015-2016), *available at*: https://www.congress.gov/bill/114th-congress/house-bill/1965.

- identify areas in which small business investors would benefit from changes to SEC regulations or SRO rules;
- identify problems that small businesses have with securing access to capital (e.g., any unique challenges to minority-owned and women-owned small businesses);
- analyze the potential impact on small businesses and investors of small businesses of the following:
    - proposed SEC regulations that are likely to have a significant economic impact on small businesses and small business capital formation; and
    - proposed SRO rules that are likely to have a significant economic impact on small businesses and small business capital formation registered under the Exchange Act;
- conduct outreach to small businesses and small business investors; and
- to the extent practicable, propose to the SEC changes in the regulations or orders of the SEC and to Congress any legislative, administrative, or personnel changes that may be appropriate to promote the interests of small businesses and small business investors.

Small Business Credit Availability. The SEC would be required under the CHOICE Act to promulgate regulations to codify the terms of an exemptive application already issued to a business development company ("BDC") allowing the BDC to own interests in an investment adviser. The CHOICE Act would expand access to capital for BDCs by changing the asset coverage requirements under the Investment Company Act for BDCs to 150 percent, if, among other things:

- within five business days of the approval of the adoption of the asset coverage requirements, the BDC discloses such approval and the date of its effectiveness in a Form 8-K filed with the SEC and in a notice on its website;
- the BDC discloses in its periodic filings made pursuant to Section 13 of the Exchange Act:
    - the aggregate value of the senior securities issued by the BDC and the asset coverage percentage as of the date of the BDC's most recent financial statements;
    - that the BDC has adopted the asset coverage requirements of Section 61(a) of the Investment Company Act and the effective date of such requirements; and
- with respect to a BDC that issues equity securities that are registered on a national securities exchange, the periodic filings of the BDC under Section 13(a) of the Exchange Act includes disclosures reasonably designed to ensure that shareholders are informed of the amount of indebtedness and asset coverage ratio of the BDC, among other information.

Foster Innovation Through Temporary Exemption for Low-Revenue Issuers. The CHOICE Act would provide a temporary exemption for "low-revenue issuers" from Section 404(b) of the Sarbanes-Oxley Act ("Section 404(b)"), which requires that a public company's public accounting firm attest to the assessment of internal controls made by the company's management. Specifically, Section 404(b) will not apply with respect to an audit report prepared for an issuer that:

- ceases to be an EGC on the last day of the fiscal year of the issuer following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act;
- had average annual gross revenues of less than $50 billion as of its most recently completed fiscal year; and
- is not a large accelerated filer, pursuant to Rule 12b-2 under the Exchange Act.

An issuer ceases to be eligible for the low-revenue exemption at the earliest of:

- the last day of the issuer's fiscal year following the tenth anniversary of the date of the first sale of the issuer's common equity securities pursuant to an effective registration statement under the Securities Act;
- the last day of the issuer's fiscal year during which the average annual gross revenues of the issuer exceed $50 billion; or
- the date on which the issuer becomes a large accelerated filer.

Enhance Small Business Capital Formation. The CHOICE Act would amend Section 503 of the Small Business Investment Incentive Act by requiring that the SEC review the findings and recommendations of the Government-Business Forum on Capital Formation (the "Forum") and, each time the Forum submits a finding or recommendation to the SEC, promptly issue a public statement that assesses the findings or recommendations of the Forum and discloses the action, if any, the SEC intends to take with respect to the findings or recommendations.

Revisions to the Prohibition Against General Solicitation and Advertising. The CHOICE Act would require the SEC to revise Regulation D under the Securities Act ("Reg D") to require that the prohibition against general solicitation or general advertising contained in Rule 502(c) of Reg D does not apply to certain presentations made at business fairs consistent the guidance contained in the Michigan Growth Capital Symposium no-action letter.

Venture Exchanges. Section 1056 of the CHOICE Act would amend Section 6 of the Exchange Act by enabling a national securities exchange to elect to be treated (for a specific listing tier of such exchange to be treated) as a "venture exchange" by notifying the SEC of such election, either at the time the exchange applies to be registered as a national securities exchange or after registering as a national securities exchange. A venture exchange would be limited to constituting, maintaining, or providing a market place or facility for bringing together purchasers and sellers of "venture securities," defined under the CHOICE Act as: (i) securities of an early-stage growth company that are exempt from registration requirements under Section 3(b) of the Securities Act; and (ii) securities of an EGC. The venture exchange would be able to determine the increment to be used for quoting and trading venture securities on the exchange and would be required to disseminate last sale and quotation information on terms that are fair and reasonable. Moreover, the venture exchange would be able to choose to carry out periodic auctions for the sale of a venture security instead of providing continuous trading of the venture security.

Safe Harbor for Micro Offerings. Section 1061 of the CHOICE Act would provide a safe harbor from Section 4 of the Securities Act for certain micro offerings, including transactions involving the sale of securities by an issuer that meet all of the following requirements:

- each purchaser (i) has a substantive, pre-existing relationship with an officer of the issuer or, a director of the issuer, or (ii) is a shareholder holding 10 percent or more of the issuer;
- there are no more than, or the issuer reasonably believes that there are no more than, 35 purchasers of securities from the issuer that are sold in reliance on the micro-offering exemption during the 12-month period preceding any such transaction;
- the aggregate amount of all securities sold by the issuer, including any amount sold in reliance on the exemption provided under the micro-offering exemption, during the 12-month period preceding such a transaction does not exceed $500,000.

Moreover, such micro offerings would be deemed covered securities under the Section 18 of the Securities Act and, therefore, exempt from state "blue sky" laws.

Improvements to Private Placements. Section 1066 of the CHOICE Act would amend Reg D in an attempt to ensure that the proposed amendments released by the Commission in July 2013 related to Reg D, Form D, and Rule 156 would be foreclosed from being adopted. Also, the CHOICE Act would revise Rule 501(a) of Reg D to provide that a person who is a "knowledgeable employee" of a private fund or the fund's investment adviser must be an accredited investor for purposes of a Rule 506 offering of a private fund with respect to which the person is a knowledgeable employee.

Investor Limitations for Qualifying Venture Capital Funds. Section 3(c)(1) of the Investment Company Act ("Section 3(c)(1)") provides an exemption for certain funds from registration under the Investment Company Act. To qualify for the 3(c)(1) exemption, the issuer would, among other things, need to have 100 or fewer U.S. holders of its securities. Section 1071 of the CHOICE Act would amend Section 3(c)(1) by allowing a "qualifying venture capital fund" to maintain holders of up to 250 U.S. persons without having to register under the Investment Company Act. A "qualifying venture capital fund" would include any venture capital fund, as defined under Section 203(l)(1) of the Investment Advisers Act, with no more than $10 million in invested capital.

Adjustments to Crowdfunding Regime. The CHOICE would amend the current crowdfunding legal regime by amending Title III of the JOBS Act to exempt crowdfunding securities from the requirements of Section 12(g) of the Exchange Act. Specifically, Section 1077 of the CHOICE Act would add a new provision under Section 4(a)(6) of the Securities Act ("Section 4(a)(6)"), which would provide an exemption for securities offered by: (i) an issuer that has a public float of less than $75 million as of the last day of the issuer's most recently completed semi-annual period; or (ii), where the total public float is zero, an issuer that had annual revenues of less than $50 million as of the issuer's most recently completed fiscal year.

Additionally, the CHOICE Act would permit single purpose funds (known as "crowdfunding vehicles") to participate in the sale and offer of crowdfunding securities.

Corporate Governance Reform and Transparency. Section 1082 of the CHOICE Act would require "proxy advisory firms," as defined under the CHOICE Act, to register under the Exchange Act before making use of the mails or any means or instrumentality of interstate commerce to provide proxy voting research, analysis, or recommendations to any client.

The proxy advisory firm would be required to file with the SEC an application for registration, containing certain information, including:

- a certification that the applicant has adequate financial and managerial resources to consistently provide proxy advice based on accurate information;
- the methodologies and procedures the applicant uses in developing proxy voting recommendations;
- the organizational structure of the proxy advisory firm;
- whether or not the proxy advisory firm has a code of ethics in effect;
- any potential or actual conflict of interest relating to the ownership structure of the proxy advisory firm or the provision of proxy advisory services; and
- the policies and procedures in place to manage conflicts of interest.

The proxy advisory firm would also be required to:

- establish, maintain, and enforce written policies and procedures reasonably designed to address and manage any conflicts of interest that can arise from such business;
- maintain sufficient levels of staffing to produce voting proxy recommendations that are based on accurate and current information;

- establish procedures sufficient to permit companies receiving proxy advisory firm recommendations a reasonable time to comment on draft versions of the recommendations;
- employ an ombudsman to receive complaints about the accuracy of voting information used in making recommendations from the subjects of the proxy advisory firm's recommendations;
- designate an individual responsible for administering the firm's required policies and procedures;
- submit, on a confidential basis, to the SEC financial statements by an independent public auditor and other information concerning the firm's financial condition; and
- at the beginning of the firm's fiscal year, report to the SEC on the number of:
    - shareholder proposals its staff reviewed in the prior fiscal year;
    - staff who received and made recommendations on such proposals in the prior fiscal year; and
    - recommendations made in the prior fiscal year where the proponent of such recommendation was a client of (or received services from) the proxy advisory firm.

III. REPEAL OF SPECIALIZED PUBLIC COMPANY DISCLOSURES FOR CONFLICT MINERALS, EXTRACTIVE INDUSTRIES, AND MINE SAFETY

Title XV of the Dodd-Frank Act imposes a number of disclosure requirements related to conflict minerals, extractive industries, and mine safety.

Section 1502. Section 1502 of the Dodd-Frank Act requires certain persons to disclose annually whether any "conflict minerals" are necessary to the functionality or production of a product of the person originated in the Democratic Republic of the Congo (the "DRC") or an adjoining country.

Section 1503. Section 1503 of the Dodd-Frank Act requires the SEC to promulgate rules that require an issuer that files reports pursuant to Section 13(a) or Section 15(d) of the Exchange Act and is an operator, or maintains a subsidiary that is an operator, of a coal or other mine to include, in each periodic report filed with the SEC, certain information for the time covered by the report, including, among other things, the total number of violations of mandatory health or safety standards that could significantly and substantially contribute to health hazards for each coal or other mine of which the issuer or a subsidiary of the issuer is an operator.

Section 1504. Section 1504 of the Dodd-Frank Act requires that the SEC issue rules that require reporting issuers engaged in resource extraction activities, including the commercial development of oil, natural gas, or minerals, to disclose in their annual reports certain payments made to the U.S. federal government or a foreign government.

IV. CAPITAL FORMATION BILLS REFLECTED IN THE CHOICE ACT

Click here to view this chart online.

Summary of Capital Formation Bills			
Bill	**Title of Bill**	**Purpose of Bill**	**Corresponding Section of the CHOICE Act**
H.R. 686	Small Business Merger, Acquisitions, Sales, and Brokerage Simplification Act	• Amends Section 15(b) of the Exchange Act to create a simplified registration system for M&A brokers.	Section 1001
H.R. 1090	Retail Investor Protection Act	• Repeals the Department of Labor's fiduciary rule and requires that the SEC, before issuing the final rule to implement Section 913 of the Dodd-Frank Act, engage in a complete analysis of the final rule's impact.	Section 441
H.R. 1675	Encouraging Employee Ownership Act	• Amends Rule 701 by requiring that the SEC increase the threshold from $5 million to $10 million and index the amount for inflation every five years.	Section 1006
H.R. 1695	Encouraging Small Company Disclosure Simplification Act	• Provides a voluntary exemption for all EGCs and other small issuers (with annual gross revenues under $250 million) from the SEC requirements to file financial statements in XBRL.	Sections 1011 to 1014
H.R. 1975	Securities and Exchange Commission Overpayment Credit Act	• Authorizes the SEC to refund overpayments of fees made by national securities exchanges and other SROs under Section 31 of the Exchange Act.	Section 1016
H.R. 2187	Fair Investment Opportunities for Professional Exports Act	• Amends the definition of "accredited investor" under the Securities Act to expand the pool of eligible investors in private securities offerings.	Section 452
H.R. 2357	Accelerating Access to Capital Act	• Amends Form S-3 for smaller reporting companies that have a class of common equity securities listed and registered on a national securities exchange.	Section 1026
H.R. 3784	SEC Small Business Advocate Act	• Establishes the Office for Small Business Capital Formation ("OSBCF") and the Small Business Capital Formation Advisory Committee within the SEC. • Requires that the OSBCF be led by the Advocate for Small Business Capital Formation.	Section 1031
H.R. 3798	Due Process Restoration Act	• Ensures fairness/protects the due process rights of defendants in SEC enforcement matters.	Sections 415 to 417
H.R. 3868	Small Business Credit Availability Act	• Amends the Investment Company Act to modernize the regulatory regime for BDCs.	Sections 1036 to 1038
H.R. 4139	Fostering Innovation Act	• Extends the period in which EGCs must comply with Section 404(b) of the Sarbanes-Oxley Act.	Section 1041
H.R. 4168	Small Business Capital Formation Enhancement Act	• Requires the SEC to respond to any findings and recommendations, within the SEC's jurisdiction, set forth by the SEC's Government-Business Forum on Small Business Capital Formation annually.	Section 1046
H.R. 4498	Helping Angels Lead our Startups (HALOS) Act	• Defines an angel investor for purposes of federal securities laws. • Clarifies the definition of general solicitation contained in the Securities Act to ensure that startup companies have the ability to discuss their products/business plans at "demo days."	Sections 1051 and 1052
H.R. 4538	Senior$afe Act of 2016	• Protects banks, credit unions, investment advisers, and broker-dealers and their employees from civil liability, as long as employees receive training in how to spot and report predatory activity against senior citizens.	Sections 1091 to 1093
H.R. 4638	Main Street Growth Act	• Amends the Exchange Act to create SEC-registered venture exchanges.	Section 1056
H.R. 4850	Micro Offering Safe Harbor Act	• Exempts certain small or "micro offerings" from the Securities Act's registration requirements.	Section 1061
H.R. 4852	Private Placement Improvement Act	• Prohibits the SEC from issuing regulations that would impede Title II of the JOBS Act.	Section 1066
H.R. 4854	Supporting America's Innovators Act	• Amends the Investment Company Act to expand the exemption from SEC registration from 100 to 250 investors for a "qualifying venture capital fund."	Section 1071
H.R. 4855	Fix Crowdfunding Act	• Amends Title III of the JOBS Act to exempt crowdfunding securities from Section 12(g) under the Exchange Act. • Permits a single purpose fund to participate in the sale and offer of crowdfunding securities.	Sections 1076 to 1077
H.R. 5019	Fair Access to Investment Research Act	• Directs the SEC to provide a safe harbor for research reports that cover exchange-traded funds so that such reports are not deemed "offers" under Section 5 of the Securities Act.	Section 1021
H.R. 5311	Corporate Governance Reform and Transparency Act of 2016	• Defines a proxy advisory firm for purposes of federal securities laws. • Requires a proxy advisory firm to register with the SEC.	Sections 1081 to 1083
H.R. 5421	National Securities Exchange Regulatory Parity Act of 2016	• Amends Section 18 of the Securities Act to provide a "blue sky" exemption for any security listed on a national securities exchange that is registered with and whose listing standards are approved by the SEC.	Section 1096

Passed the Financial Services Committee only (as of Sept. 2016) Passed the U.S. House of Representatives

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