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Financial Choice Act 2.0 Has Made Progress

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On June 8, 2017, the U.S. House of Representative passed the Financial Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs Act (the "Financial Choice Act 2.0" or the "Act") by a vote of 283-186 along party lines. Only one Republican did not vote in favor of the Act. On May 4, 2017, the House Financial Services Committee voted to approve the Act. A prior version of the Act was adopted by the Financial Services Committee in September 2016 but never proceeded to the House for a vote.

The Financial Choice Act 2.0 is an extensive, extreme piece of legislation that would dismantle a large amount of the power of the SEC and strip the Dodd-Frank Act of many of its key provisions. The future of the Act is uncertain as it is unlikely to get through the Senate, although a rollback of Dodd-Frank remains a priority to the current administration. It is also possible that parts of the lengthy Act could be bifurcated out and included in other Acts that ultimately are passed into law.

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Introduction

The Executive Summary for the as presented to the House lists the following seven key principles of the Act:

> Taxpayer bailouts of financial institutions must end and no company can remain “too big to fail”;
>
> Both Wall Street and Washington must be held accountable;
>
> Simplicity must replace complexity, because complexity can be gamed by the well-connected and abused by the Washington powerful;
>
> Economic growth must be revitalized through competitive, transparent, and innovative capital markets;
>
> Every American, regardless of their circumstances, must have the opportunity to achieve financial independence;
>
> Consumers must be vigorously protected from fraud and deception as well as the loss of economic liberty; and
>
> Systemic risk must be managed in a market with profit and loss.

The Act focuses on dismantling Dodd-Frank, including the controversial Volcker Rule, which prohibits banks from engaging in proprietary trading; the U.S. Department of Labor fiduciary rule, which went into effect on June 9, 2017; and the “too big to fail” provisions allowing for federal government bailouts. Among many provisions directly impacting the authority of the SEC, the Act would strip the SEC of the power to use administrative proceedings as an enforcement tool.

Summary of Key Provisions

Executive Compensation

Many of the changes would repeal provisions related to executive compensation. Related to executive compensation, the Financial Choice Act would include:

Pay Ratio. The Act would repeal the section of Dodd-Frank which requires companies to disclose the pay ratio between CEO's and the median employees.. This rule is under scrutiny and attack separately and apart from the Financial Choice Act as well. On February 6, 2017, acting SEC Chair Michael Piwowar called for the SEC to conduct an expedited review of the rule for the purpose of reconsidering its implementation. It is highly likely that this rule will not be implemented as written, if at all.

Incentive-based Compensation. The Act would repeal provisions of Dodd-Frank that require enhanced disclosure related to incentive-based compensation by certain institutions.

Hedging. Proposal to repeal the section of Dodd-Frank which requires companies to disclose whether employees or directors can offset any increase in market value of the company's equity grants as compensation.

Say on Pay. The Act will amend the Say on Pay rules such that the current advisory vote would only be necessary in years when there has been a material change to compensation arrangements, as opposed to the current requirement that a vote be held at least once every 3 years.

Clawback Rules. The Clawback rules would prohibit companies from listing on an exchange unless such company has policies allowing for the clawback of executive compensation under certain circumstances. This would be in the form of additional corporate governance requirements.The Act will amend the clawback rules such that they will only apply to current and former executives that had "control or authority" over the company's financial statements.

On the bank-specific side, the Act would eliminate bank prohibitions on capital distributions and limitations on mergers, consolidations, or acquisitions of assets or

control to the extent that these limitations relate to capital or liquidity standards or concentrations of deposits or assets.

Key Provisions on Securities Laws

Key provisions directly impacting the federal securities laws and potentially my client base:

1. An increase in the Sarbanes-Oxley Act (“SOX”) Rule 404(b) compliance threshold from $250 million public float to $500 million. Currently smaller reporting companies and emerging-growth companies are exempted from compliance with Rule 404(b). A “smaller reporting company” is currently defined in Securities Act rule 405, Exchange Act Rule 12b-2 and Item 10(f) of Regulation S-K, as one that: (i) has a public float of less than $75 million as of the last day of their most recently completed second fiscal quarter; or (ii) a zero public float and annual revenues of less than $50 million during the most recently completed fiscal year for which audited financial statements are available.

Interestingly, when the SEC proposed an increase in the threshold definition of “smaller reporting company” in June of last year from $75 million to $250 million, it specifically chose to concurrently amend the definition of an “accelerated filer” to eliminate the benefit of an exclusion from the SOX 404(b) requirements for companies with a float over $75 million. In particular, the SEC proposed to amend the definition of “accelerated filer” to eliminate an exclusion for smaller reporting companies such that a company could be a smaller reporting company but also an accelerated filer. The SEC noted in its rule release that it intended to be sure that companies with a float over $75 million, whether a smaller reporting company or not, would have to comply with SOX 404(b) and the accelerated filing schedule for quarterly and annual reports. If passed, the Financial Choice Act 2.0 would override the SEC’s current proposal on this point.

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2. The Financial Choice Act 2.0 would increase the registration threshold requirements under Section 12(g) of the Securities Exchange Act for smaller companies. The Act 2.0 would also index the thresholds for inflation moving forward. In addition, the Act would eliminate the requirement to obtain ongoing accredited investor verifications for determining the Section 12(g) registration requirements. On May 1, 2016, the SEC amended Exchange Act Rules 12g-1 through 12g-4 and 12h-3 related to the procedures for termination of registration under Section 12(g) through the filing of a Form 15 and for suspension of reporting obligations under Section 15(d), to reflect the higher thresholds set by the JOBS Act. The SEC also made clarifying amendments to: (i) cross-reference the definition of "accredited investor" found in rule 501 of Regulation D, with the Section 12(g) registration requirements; (ii) add the date for making the registration determination (last day of fiscal year-end); and (iii) amend the definition of "held of record" to exclude persons who received shares under certain employee compensation plans. Under the rules, a company that is not a bank, bank holding company or savings-and-loan holding company is required to register under Section 12(g) of the Exchange Act if, as of the last day of its most recent fiscal year-end, it has more than $10 million in assets and securities that are held of record by more than 2,000 persons, or 500 persons that are not accredited. Investors are not necessarily responsive to inquiries from a company and may balk at providing personal information, especially those that have purchased in the open market but then subsequently, for whatever reason, converted such ownership to certificate/book entry or otherwise "record ownership."

3. The Financial Choice Act 2.0 would expand the coverage under Title 1 of the JOBS Act to allow all companies to engage in certain test-the-waters communications in an IPO process and to file registration statements on a confidential basis. Title 1 of the JOBS Act specifically only applies to emerging-growth companies (EGC's). In particular, Section 105(c) of the JOBS Act provides an EGC with the flexibility to "test the waters" by engaging in oral or written communications with qualified institutional buyers ("QIB's") and institutional accredited investors ("IAI's") in order to gauge their interest in a proposed offering, whether prior to (irrespective of the 30-day safe harbor) or following the first filing of any registration statement, subject to the requirement that no security may be sold unless accompanied or preceded by a Section 10(a) prospectus. Generally, in order to be considered a QIB, you must own and invest $100 million of securities, and in order to be considered an IAI, you must have a minimum of $5 million in assets.

The Financial Choice Act 2.0 will also expand the ability to file a registration statement on a confidential basis to all companies and not just EGC's. Currently, an EGC may initiate the "initial public offering" ("IPO") process by submitting its IPO registration statements confidentially to the SEC for nonpublic review by the SEC staff. A confidentially submitted registration statement is not deemed filed under the Securities Act and accordingly is not required to be signed by an officer or director of the issuer or include auditor consent. Signatures and auditor consent are required no later than 15 days prior to commencing a "road show." If the EGC does not conduct a traditional road show, then the registration statements and confidential submissions must be publicly filed no later than 15 days prior to the anticipated effectiveness date of the registration statement. I note that the JOBS Act had originally set the number of days for submission of all information at 21 days and the FAST Act shortened that time period to 15 days.

4. A requirement that the SEC Chair conduct a study and issue a report on self-regulatory organizations, including recommendations to eliminate duplications and inefficiencies amongst the various organizations.

5. The Financial Choice Act 2.0 would increase the allowable offering amount for Tier 2 of Regulation A (i.e., Regulation A+) from $50 million to $75 million in any 12-month period. I often write about Regulation A/A+.

6. The Financial Choice Act 2.0 would prohibit the SEC from requiring the use of “universal proxies” in contested elections of directors. Pre-change in administration, on October 16, 2016, the SEC proposed a rule requiring the use of the use of universal proxy cards in connection with contested elections of directors. The proposed card would include the names of both the company and opposed nominees. The SEC also proposed amendments to the rules related to the disclosure of voting options and standards for the election of directors.

7. An inflation update to the minimum thresholds for shareholders to be able to submit proposals for annual meetings. Currently Rule 14a-8 permits qualifying shareholders to submit matters for inclusion in the company’s proxy statement for consideration by the shareholders at the company’s annual meetings. Procedurally to submit a matter, among other qualifications, a shareholder must have continuously held a minimum of $2,000 in market value or 1% of the company’s securities entitled to vote on the subject proposal, for at least one year prior to the date the proposal is submitted and through the date of the annual meeting.The Financial Choice Act 2.0 would update the ownership requirement thresholds for inflation.

8. Delay the repeal of the Chevron doctrine for two years. Under the Chevron doctrine, a court must defer to an agency’s interpretation of statutes and rules. The Financial Choice Act called for the immediate repeal of this doctrine. The Act 2.0 would delay such repeal for two years.

9. Increase the limits on disclosure requirements for employee-issued securities under Rule 701 from $10 million as set forth in version 1.0 to $20 million with an inflation adjustment. Rule 701 of the Securities Act provides an exemption from the registration requirements for the issuance of securities under written compensatory benefit plans. Rule 701 is a specialized exemption for private or non-reporting entities and may not be relied upon by companies that are subject to the reporting requirements of the Securities Exchange Act of 1934, as amended ("Exchange Act"). The Rule 701 exemption is only available to the issuing company and may not be relied upon for the resale of securities, whether by an affiliate or non-affiliate. Currently, additional disclosures are required for issuance valued at $5 million or more in any 12-month period.

10. The Act seeks to shift enforcement and penalties away from companies and towards individual officers, directors and other offenders. The SEC would be required to conduct an economic analysis before enforcing civil penalties against a company, to ensure that the company itself benefited from the alleged wrongdoing. The intent is to prevent harm to innocent shareholders by penalizing a company for the wrongdoing of individuals. Likewise, the Act will increase the penalties that can be imposed against individuals by two and in some cases three times the current amounts where the penalties are tied to the defendant's illegal profits. The Act would give the SEC new authority to impose sanctions equal to investor losses in cases involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement" and increase the stakes for repeat offenders. Moreover, the Act will increase the maximum criminal fines for persons that engage in insider trading or other corrupt practices.

11. The Act would strip the SEC of the power to use administrative proceedings as an enforcement tool. The new law would permit a respondent to remove any administrative proceeding to a federal district court. Moreover, the Act would raise the SEC's standard of proof in administrative proceedings from "preponderance of evidence" to the higher "clear and convincing" evidence of wrongdoing.

12. The Act would reduce the SEC's enforcement power in other areas as well. The duration of both the SEC's and CFTC's subpoena power would be reduced. All investigations would be subject to a process for timely conclusion. Respondents would also be guaranteed access to commissioners at the Wells process stage (before a formal complaint). In addition, the Act would restrict the SEC's ability to leverage settlement by threatening the company or individual with automatic disqualification from regulated activities. Instead, disqualification would now require a formal hearing. The SEC would also have to publish its enforcement manual, providing further transparency into filing decisions.

13. The Act would require that all fines collected by the PCAOB and Municipal Securities Rulemaking Board be remitted to the Treasury for deficit reduction.

Too Big to Fail Bailouts

Related to bailouts, the Financial Choice Act 2.0 would, in summary:

Repeal the authority of the Financial Stability Oversight Council to designate firms as systematically important financial institutions (i.e., "too big to fail");

Repeal Title II of Dodd-Frank and replace it with new bankruptcy code provisions specifically designed to accommodate large, complex financial institutions. Title II of Dodd-Frank is the orderly liquidation authority, granting authority to the federal government to obtain receivership control over large financial institutions;

Repeal Title VIII of Dodd-Frank, which gives the Financial Stability Oversight Council access to the Federal Reserve discount window for systematically important financial institutions (i.e., gives the federal government the money to bail out financial institutions) as well as the authority to conduct examinations and enforcement related to risk management;

Restrict the Federal Reserve's discount window lending to Bagehot's dictum; and

Prohibit the use of the Exchange Stabilization fund to bail out financial firms or creditors.

Financial Regulator Accountability

Related to accountability from financial regulators, the Act would:

1. Make all financial regulatory agencies subject to the REINS Act related to appropriations and place all such agencies on an appropriations process subject to congressional control and oversight;
2. Require all financial regulators to conduct a detailed cost-benefit analysis for all proposed regulations to ensure that benefits outweigh costs (provisions analogous to this are already required, but this would be more extreme);
3. Increase transparency of financial regulations' costs to state and local governments and private-sector entities;
4. Reauthorize the SEC for a period of 5 years with funding, structural and enforcement reforms (i.e., dismantle the current SEC and replace it with a watered-down version);
5. "Institute significant due-process reforms for every American who feels that they have been the victim of a government shakedown";
6. Repeal the Chevron Deference doctrine. Under this doctrine, a court must defer to an agency's interpretation of statues and rules;
7. Demand greater accountability and transparency from the Federal Reserve, both in its conduct of monetary policy and its prudential regulatory activity, by including the House-passed Fed Oversight Reform and Modernization Act;
8. Abolish the Office of Financial Research;
9. Require public notice and comment for any international standard-setting negotiation;
10. Prohibit the financial regulators and DOJ from using settlement agreements to require donations to non-victims;

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11. Increase transparency and accountability in the Federal Reserve's conduct of the supervisory stress tests while streamlining duplicative and overly burdensome components; and

12. Institute criminal penalties for leaks of sensitive, market-moving information related to the Federal Reserve's stress-test and living-will processes.

Financial Institutions

The Act intends to create strongly capitalized, well-managed financial institutions by:

1. Providing an "off-ramp" from the post-Dodd-Frank supervisory regime and Basel III capital and liquidity standards for banking organizations that choose to maintain high levels of capital. Any banking organization that makes a qualifying capital election but fails to maintain the specified non-risk-weighted leverage ratio will lose its regulatory relief;

2. Exempting banking organizations that have made a qualifying capital election from any federal law, rule or regulation that provides limitations on mergers, consolidations, or acquisitions of assets or control, to the extent that the limitations relate to capital or liquidity standards or concentrations of deposits or assets; and

3. Exempting banking organizations that have made a qualifying capital election from any federal rule, law or regulation that permits a banking agency to consider risk "to the stability of the US banking or financial system" which was added to various federal banking laws by Section 604 of Dodd-Frank, when reviewing an application to consummate a transaction or commence an activity.

Miscellaneous Provisions

Under the heading "[U]leash opportunities for small businesses, innovators, and job creators by facilitating capital formation," the Act would:

1. Repeal multiple sections of Dodd-Frank, including the Volker Rule (which restricts U.S. banks from making speculative investments, including proprietary trading, venture capital and merchant bank activities);

2. Repeal the SEC's authority to either prospectively or retroactively eliminate or restrict securities arbitration;

3. Repeal Dodd-Frank's non-material specialized disclosure; and

4. Incorporate more than two dozen committee- or House-passed capital formation bills, including H.R. 1090 – Retail Investor Protection Act (prohibiting certain restrictions on investment advisors), H.R. 1312 – Small Business Capital Formation Enhancement Act (requiring prompt SEC action on finding of the annual SEC government business forum), H.R. 79 – Helping Angels Lead Our Startups Act (directing the SEC to amend Regulation D, expanding the allowable use of solicitation and advertising), and H.R. 910 – Fair Access to Investment Research Act (expanding exclusion of research reports from the definition of an offer for or to sell securities under the Securities Act).

The Act also contains numerous provisions related to small community financial institutions, as well as many provisions fundamentally changing the Consumer Financial Protection Bureau.

Dodd-Frank Budget Cuts

A few articles have indicated that President Trump's fiscal 2018 budget proposal would include a restructure of the U.S. Consumer Financial Protection Bureau (CFPB), which was created by the Dodd-Frank Act. The purpose of the CFPB is to protect borrowers from predatory lending. The restructure would reduce the federal deficit by $145 million in the 2018 fiscal year. The CFPB has been under attack by the administration. Last year, a U.S. appeals court found that the CFPB structure violated the Constitution, a decision that is currently being appealed.

The SEC reserve fund, which was also created under Dodd-Frank, would also be eliminated. Currently the reserve fund is $50 million a year and is used by the SEC to overhaul its information technology, including upgrades to the EDGAR filing system and initiatives to police fraud and track equities trading patterns.

The remainder of the SEC budget would remain unchanged as it is considered deficit-neutral because the fees it collects from enforcement are matched by congressional funding.

Thoughts

In recent years we have seen the most dramatic changes in capital formation regulations and technological developments in the past 30 years, if not longer. Significant capital-formation changes include: (i) the creation of Rule 506(c), which came into effect on September 23, 2013, and allows for general solicitation and advertising in private offerings where the purchasers are limited to accredited investors; (ii) the overhaul of Regulation A, creating two tiers of offerings which came into effect on June 19, 2015, and allows for both pre-filing and post-filing marketing of an offering, called "testing the waters"; (iii) the addition of Section 5(d) of the Securities Act, which came into effect in April 2012, permitting emerging-growth companies to test the waters by engaging in pre- and post-filing communications with qualified institutional buyers or institutions that are accredited investors; and (iv) Title III crowdfunding, which came into effect on May 19, 2016, and allows for the use of Internet-based marketing and sales of securities offerings.

At the same time, we faced economic stagnation since the recession, a 7-year period of near-zero U.S. interest rates and negative interest rates in some foreign nations, nominal inflation and a near elimination of traditional bank financing for start-ups and emerging companies. If bank credit were available for small and emerging-growth companies, it would be inexpensive financing, but it is not and I do believe that Dodd-Frank and over-regulation are directly responsible for this particular problem.

In my practice, optimism and growth remain the buzzwords. My clients are universally enthusiastic about the state of the economy and business prospects as a whole. The consistent mantra of decreasing regulations is universally welcomed with a sense of relief. The SEC will not be immune to these changes, and we are just beginning to see what I believe will be an avalanche of positive change for small businesses and capital formation.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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