Title IV: UNLEASHING OPPORTUNITIES FOR SMALL BUSINESSES, INNOVATORS, AND JOB CREATORS BY FACILITATING CAPITAL FORMATION

Title IV of CHOICE Act 2.0 primarily alleviates certain current restrictions on issuers of securities from accessing the capital markets. In several cases, exemptions to current registration, disclosure or regulatory requirements would be implemented or expanded. Key changes include:

M&A Brokers

Exempting from broker-dealer registration certain M&A brokers intermediating the sales of "eligible privately-held companies," which generally refers to small- and mid-sized privately-owned companies with pre-tax earnings less than $25 million or gross revenues less than $250 million. This provision codifies the exemption from the broker-dealer registration requirement for M&A brokers originally set forth in SEC no-action letter issued on February 4, 2013. The SEC no-action letter exempted M&A brokers from the registration requirement regardless of the size of company.[1]

Triggering for Public Company Registration and Deregistration

Expanding a registration exemption under Section 12(g) of the Exchange Act by eliminating the provision that requires a private company to register its securities under Section 12(g) of the Exchange Act if it has a class of equity security that is held of record by at least 500 persons who are not accredited investors, while maintaining the $10 million total asset test, which would be indexed to inflation on a five-year cycle, and the 2,000 person record holder trigger. The amendment would also permit companies to deregister when they have 1,200 shareholders, increased from 300 holders.

New Micro Offering Exemption

New exemption from federal and state registration requirements introduced for "micro offerings," which are offerings of less than an aggregate amount of $500,000 in a 12-month period and sold to no more than 35 purchasers each having a substantial pre-existing relationship with an officer or director of the issuer or is an existing 10% shareholder.

Revamped Crowdfunding Exemption

Replacing the existing crowdfunding rules issued by the SEC in 2015 completely with a new exemption providing significant additional flexibility, including: (i) no apparent caps or limits on aggregate offering amounts or investment limits; (ii) no financial statement or specific disclosure requirements; (iii) no investor financial qualifications,

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[1] For more information regarding the SEC no-action letter, you may wish to refer to our client publication "SEC Offers Relief to M&A Brokers," available at: http://www.shearman.com/~/media/files/newsinsights/publications/2014/02/secoffersrelieftomabrokersfiafr022114.pdf.

permitting crowdfunding offerings without use of an intermediary; and (iv) no requirement for intermediaries to be registered as broker dealers. Additionally, crowdfunding investors would be excluded from the Section 12(g) calculation. The SEC is required to implement the necessary rules to effect these amendments within six months of the enactment of the bill.

Relief from the Sarbanes-Oxley Act 404(b) Requirement for Low Revenue IPO Companies

The exemption provided to a new public company from having its auditor attest and report on management's assessment of internal controls would be extended for companies that lose emerging growth company status after five years if their average gross revenue over the preceding three years was less than $50 million, until the earlier of their average gross revenue exceeding $50 million or ten years from its initial public offering.

Expansion of the 4(1½) Exemption for Private Resales

The existing exemption for certain non-issuer private resales, which was adopted as part of the FAST Act, would be expanded to remove information requirements and to permit general solicitation, so long as all sales are made through a platform that is only available to accredited investors.

Relief from XBRL Filing Requirements

Emerging growth companies and companies with total annual gross revenues of less than $250 million would be exempted from XBRL filing requirements. The XBRL exemption would need to be made effective within 60 days of the enactment of the bill. Further, the SEC would be required to conduct various cost-benefit analyses in connection with these exemptions and report such findings to Congress.

Issuances of Securities to Employees under Rule 701

Directing the SEC to increase the threshold on the exemption under Rule 701 that requires companies to provide more comprehensive disclosures in connection with the issuance of securities to their employees pursuant to employee benefit plans from $5 million sold in a 12-month period to $20 million. The SEC is required to implement the necessary rules to effect these amendments within 60 days of the enactment of the bill.

Business Development Companies and Closed End Funds

Removing certain limits on investments made by business development companies ("BDCs") as the term is defined under the '40 Act. Central to the definition of a BDC under the '40 Act is that they are limited in the type of companies they are permitted to invest in. CHOICE Act 2.0 expands the definition of "eligible portfolio company" to include certain financial companies. The legislation also removes limits placed by Section 12 of the '40 Act for BDCs investing in investment advisers.

Lowering asset coverage requirements for BDCs from 200% to 150%%, if those BDCs disclose certain financials in a Form 8-K. This has the effect of a BDC being able to lever a greater amount of its assets.

CHOICE Act 2.0 also directs the SEC to revise rules to permit BDCs to file offering materials and proxy statements under the rules applicable to other non-investment company issuers and allows BDCs to qualify as WKSIs. Being a WKSI offers significant advantages for offering securities under the Securities Act, such as automatic shelf registration (not subject to the SEC review process)and significantly lower registration fees for shares (only pay on take down and can register an unlimited number of securities).

The legislation also permits BDCs to use Form S-3 for registering securities that otherwise meet the criteria for registering such securities under Form S-3, as well as the applicable proxy rules.

Additionally, similar to the expansion for BDCs, the SEC would be directed to permit closed-end funds to make use of a number of the securities offering and offering communication rules that are currently unavailable to closed-end funds including permitting treatment of closed-end funds as WKSIs.

The SEC would be required to implement necessary rules within one year, but BDCs and closed-end funds can take advantage of the provisions after the one year period, whether or not the implementing rules are adopted.

JOBS Act Benefits Extended to All IPO Companies

Extending the JOBS Act provisions to allow any issuer, not just emerging growth companies, to engage in "testing the waters" communications with potential investors before filing an initial public offering ("IPO") registration statement and to allow any company to submit an IPO registration statement for SEC review on a confidential basis. A company would be required to make its first public filing with the SEC of its IPO 15 days before the roadshow, reduced from 21 days.[2]

Shelf Offerings for Smaller Companies

Directing the SEC to expand S-3 eligibility to allow issuers that do not meet the $75 million minimum public float requirement to register securities under Form S-3 if they have at least one class of common equity securities listed on a national securities exchange. Also, CHOICE Act 2.0 directs the SEC to broaden the eligibility for limited

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[2] On June 29, 2017, the SEC's Division of Corporation Finance announced that, beginning on July 10, 2017, it will permit confidential submissions of draft registration statements for all IPOs, including by issuers that do not qualify as emerging growth companies under the JOBS Act. For more information, you may wish to refer to our client publication "SEC to Permit Confidential of Draft Registration Statements for All IPOs and Spin-Offs, Including by Non-EGCs," available at: http://www.shearman.com/en/newsinsights/publications/2017/06/confidential-submission-of-draft-registration

primary offerings by eliminating the requirement to have a class of common equity securities listed on a national securities exchange. These amendments are to take effect within 60 days of enactment of the bill.

Regulation A+

Increasing the maximum allowable offering amount for Regulation A+ offerings from up to $50 million to $75 million, with indexing for inflation every two years.

Preempting State Securities Laws

Extending state securities registration preemption to all securities listed on a national stock exchange that has listing standards approved by SEC.

Mandating Registration and Standards for Proxy Advisory Firms

Requiring proxy advisory firms to register with and be subject to regulation by the SEC, with requirements related to adequacy of internal resources, disclosure of conflicts of interest and recommendation methodologies. Additionally, includes an annual report requirement detailing shareholder proposals reviewed, the staff used to prepare recommendations and any conflicts related to such recommendations. SEC would be required to implement necessary rules within six months, which must be effective within one year.

Venture Exchanges

Creating venture exchanges that would list the securities of smaller companies and exempt such exchanges from compliance with certain regulations applicable to national securities exchanges including using decimal pricing.

Qualifying Venture Capital Funds

Adding a new exemption for certain venture capital funds under section 3(c)(1) of the ‘40 Act, which exempts certain entities from being an investment company. Venture capital funds with less than $50 million in aggregate capital contributions and uncalled committed capital (adjusted annually to reflect inflation) may have up to 500 beneficial owners, rather than being limited to 100 beneficial owners as previously applied for 3(c)(1) offerings.

Safe Harbor for Investment Fund Research

Providing relief to producers or distributors of research covering mutual funds and ETFs (and other covered funds) who participate in the offering of the covered mutual funds and ETFs under the Securities Act by expanding upon the safe harbor provided in Rule 139 of the Securities Act. The current rule requires a registrant to meet the requirements of Form S-3 or F-3 and: (i) meet the minimum float provision (greater than $75 million in market capitalization), (ii) have filed all required periodic reports during the preceding 12 months, and (iii) not be a blank check company, shell company or issuer of penny stock. In addition, to qualify the person that publishes or distributes such research reports must be doing so in the regular course of its business and the report itself may not be initiating or reestablishing such coverage.

<u>CHOICE Act 2.0 adds research reports about "covered investment funds" (i.e. mutual funds or ETFs) to the safe harbor and makes it more flexible because it:</u>

- prohibits the SEC from substantially conditioning the safe harbor upon whether such publication or distribution of the research report represents the initiation or re-initiation of the coverage on the fund or its securities by the broker or dealer;
- prohibits the SEC from requiring the fund to have been a registered investment company prior to the distribution or publication of the report;
- prohibits the SEC from requiring the fund to be subject to the reporting requirements of section 13 or 15(d) of the Exchange Act prior to the distribution or publication of the report;
- prohibits the SEC from imposing an increase to the minimum float standards that apply to covered funds past those set out in Rule 139;
- requires the SEC to prevent self-regulatory organizations from maintaining or enforcing any rules that would undermine the ability of their members to rely on this section (e.g., prohibiting a member from publishing a covered investment fund research report solely because such member is participating in the offering); and
- exempts the fund research report from the filing requirements under section 24(b) of the Investment Company Act and the rules and regulations thereunder if subject to similar standards set by a self-regulatory organizations.

The antifraud and anti-manipulation provisions of the Federal securities laws and rules still apply to the publishers and distributors of research reports on such funds, which means those seeking to rely on the safe harbor should carefully consider their procedures and practices with respect to the management of conflicts of interest. Self-regulatory organizations may also examine or supervise a member's practice to comply with Federal securities laws or self-regulatory organization rules. Pursuant to Section 421(d), the safe harbor becomes effective 120-days after the enactment of CHOICE Act 2.0 even if the SEC has not adopted the revisions and may be relied on until the SEC does adopt implementing regulations.

<u>Senior Citizen Protections</u>

Granting immunity for certain individuals, and their employer institutions, who disclose the possible financial exploitation of senior citizens.

<u>Section 31 Fees</u>

SEC would be required to return or offset any overpayments of Section 31 fees to FINRA and national securities exchanges; and promptly issue a statement responding to each recommendation made as part of the Annual Small Business Forum held by the SEC, including the actions the SEC intends to take in response to each recommendation.

Revisions to Regulation D

Several of the proposals in CHOICE Act 2.0 are aimed at streamlining the process for Rule 506(c) offerings. Rule 506(c) of Regulation D was adopted pursuant to the JOBS Act to allow for general solicitation in certain private offering to accredited investors, but the SEC had subsequently proposed rules that would have added substantial restrictions on such an offering. Several of those proposed rules would have extended to other categories of Regulation D offerings as well. CHOICE Act 2.0 seeks to restrict the ability of the SEC to adopt rules related to many of its proposals. Key provisions are:

- issuers offering or selling securities in reliance on Rule 506 must file a single Form D for each new offering of securities, and the SEC can require this filing no earlier than 15 days after the first sale. This restricts the ability of the SEC to adopt a rule that it had proposed to require a "pre-marketing" Form D filing, and potentially also obviates the need for annual or other Form D updates.
- availability of Rule 506 exemption shall not be conditioned on the issuer filing the Form D or any similar report. Proposed SEC rules had introduced a penalty of being temporarily disqualified from Rule 506 reliance if a previous offering did not comply with Form D filing requirements.
- issuers are not required to submit written general solicitation materials to the SEC for a Rule 506(c) offering (other than as requested by the SEC in connection with certain disciplinary proceedings). The SEC's proposed rules had required the filing of such materials with the SEC.
- Form D filings shall be made available to the securities commission of each state and territory.
- SEC shall not extend the requirements contained in Rule 156 (investment company sales literature) to private funds.
- Rule 501(a) must provide that a person who is a "knowledgeable employee" of a private fund or such fund's investment adviser, shall be an accredited investor for purposes of a Rule 506 offering of such private fund.

The SEC would be required to implement necessary rules within 45 days of enactment of the bill, which is an unusually short period of time for SEC rulemaking.

Additional Clarification on General Solicitation

Directing the SEC to revise the definition of general solicitation to exclude certain types of presentations and related communications made at events sponsored by venture or angel investor groups, trade or governmental organizations, educational institutions or non-profits. These events must not provide investment advice or recommendations or charge for attendance and advertisements should not reference specific securities offerings. The SEC is required to implement the necessary rules to effect these amendments within six months of the enactment of the bill.