Title VIII: CAPITAL MARKETS IMPROVEMENTS

Title VIII of CHOICE Act 2.0 makes changes to the SEC's organization, funding and enforcement powers in addition to amending certain rules applicable to ratings agencies and shareholder proposals and proxy rules. It also repeals, amends or eliminates several provisions in the Dodd-Frank Act mandating rulemaking, studies and reports by the SEC.

SEC Funding

The bill sets appropriation authorization amounts for the SEC through fiscal year 2022, requires the SEC to report on unobligated appropriations, restricts the SEC's use of funds for a new headquarters and abolishes the SEC's reserve fund, which has generally been used to fund technology modernization investments. The bill would also require that transaction and other fees collected by the SEC be transferred to the Department of the Treasury.

SEC Organization, Structure and Operation

The bill would make several changes to the SEC's current organization and reporting structure, including requiring the SEC to implement the recommendations in the 2011 report from Boston Consulting Group[3] and shifting the Offices of Credit Ratings and Municipal Securities to report to the Director of the Division of Trading and Markets rather than the Chair of the SEC.

The bill would also require that the ombudsman associated with the Office of the Investor Advocate be appointed by the SEC and would revise the responsibilities of the Investor Advocate to prohibit the Investor Advocate from taking a position on legislation pending before Congress, unless it is legislation proposed by the Investor Advocate. It would also require the Investor Advocate to consult with the Advocate for Small Business Capital Formation on recommendations.

Similarly, the bill would restructure the operation of the Investor Advisory Committee to work and consult with the Small Business Capital Formation Advisory Committee. The Investor Advisory Committee would also be required to include a member of the Small Business Capital Formation Advisory Committee on the committee.

The bill would also limit the length of the self-regulatory organization created pilot programs to five years, unless the SEC adopts a rule to extend it.

CHOICE Act 2.0 would also require the SEC to provide notice and comment required under the Administrative Procedures Act for any SEC statement, guidance, interpretive rules, or general policy statements that are voted on by the SEC Commissioners These types of the statements and guidance are not usually voted on by the SEC Commissioners.

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[3] A copy of this report is available at: https://www.sec.gov/news/studies/2011/967study.pdf.

Enforcement

CHOICE Act 2.0 also amends the SEC's enforcement powers, organization, policies and procedures. With regard to enforcement actions themselves, the bill prohibits any person from being subject to an enforcement action for a violation of securities laws if that person has not received adequate notice of the violated rule, law, or regulation. If the SEC has provided notice and comment for any SEC-voted statement or guidance in accordance with Section 553 of the Administrative Procedure Act, then adequate notice has been provided. In addition, the bill would provide that any person in receipt of a Wells notice indicating that SEC staff has recommended that an enforcement action should be brought against the aforementioned person to have the opportunity to make an in-person presentation to the SEC regarding the recommendation and be represented by counsel at such presentation, which SEC Commissioners may attend. Each SEC Commissioner shall receive a written report from SEC staff on such presentation prior to voting whether to bring the action.

The SEC would also be required to create an advisory committee to analyze and report on its enforcement policies and practices that would culminate with a series of recommendations to the SEC. The SEC would appoint an enforcement ombudsman to deal with problems that persons subject to investigations or administrative proceedings by the SEC may have with the staff or the SEC and who would create procedures for confidential communications.

In addition, the bill would require the SEC to approve and publish within one year an updated enforcement manual and to produce an updated enforcement report highlighting, among other things, past enforcement actions and future enforcement priorities. The manual would include policies and procedures of the SEC to ensure transparency.

The bill would also limit the SEC's enforcement powers and options, such as by:

- permitting persons subject to an administrative proceeding brought by the SEC, which may result in a cease and desist order or monetary penalty, to request termination of such proceeding. In such case, the SEC would be permitted to bring a civil action against that person for the same remedy;
- requiring the SEC to establish by clear and convincing evidence that a person has violated the relevant provision(s) of the securities laws in an administrative proceeding;
- eliminating the SEC's ability to issue an order in an administrative proceeding that bars persons from serving as officers or directors of an issuer;
- requiring all civil money penalties imposed on an issuer to contain an analysis by the Division of Economic and Risk Analysis concerning whether the alleged violation resulted in a direct economic benefit to the issuer, and whether the penalty would harm the issuer's shareholders;

- limiting the duration and requiring SEC approval for renewal of omnibus orders of investigation by the SEC;
- eliminating compensation for whistleblowers where the whistleblower is responsible or complicit in the securities law violation;
- eliminating automatic disqualifications of persons who previously violated securities laws, violated certain SEC rules or regulations or respective antifraud provisions, were convicted of a felony or misdemeanor, were the subject of any judicial or administrative judgment, or were suspended or barred from a registered national securities exchange from utilizing an exemption or registration provision, engaging in an activity, or qualifying for similar treatment under a provision of the securities laws or SEC rules; and
- requiring the complaint in shareholder derivative suits brought on behalf of a registered investment company be pled with particularity and would set the burden of proof for proving a breach of fiduciary duty at "clear and convincing evidence."

Process for Closing Investigations

Within 180 days after enactment of the bill, the SEC would establish a process for closing investigations in a timely manner. The process would be designed to ensure that the SEC makes a determination whether to institute a proceeding, and if not, to inform the person or entity subject to the investigation that the matter has been closed.

The SEC must:

- Make a determination whether or not to institute an administrative or judicial action in the matter or refer it to the Attorney General.
- If such matter is not pursued, the SEC must inform the affected person(s) that the investigation is closed.

The bill permits the SEC to reopen an investigation if the SEC obtains new evidence and subject to the applicable statute of limitations.

Intellectual Property (e.g., for Algorithmic Traders)

The bill would prohibit the SEC from requiring a person to produce or furnish source code, including algorithmic trading source code or similar intellectual property, without first issuing a subpoena by limiting the SEC's authority to request such information under section 8 of the Securities Act and section 23 of the Exchange Act for a person, under section 31 of the '40 Act for an investment company and/or under section 204 of the Advisers Act for an adviser.

Limitations on Say on Pay

The Dodd-Frank Act requires each issuer to provide its shareholders with a non-binding resolution approving the compensation of executives as disclosed pursuant to Item 402 of Regulation S-K. The vote must occur at least once every three years. In addition, once

every six years the shareholders are to be provided with a non-binding resolution to determine whether the aforementioned say-on-pay vote is to occur every one, two or three years. CHOICE Act 2.0 would only require the say-on-pay vote in those years in which there had been a material change to the compensation of executives from the previous year.

Restrictions on the Shareholder Proposal Process

Significant amendments to the rules related to the submission of shareholder proposals would also be made, including:

- allowing a company to exclude previously submitted shareholder proposals from its proxy materials where the shareholder proposal received less than 6% of the vote if proposed once within last five calendar years, less than 15% of the vote on its last submission if proposed twice within the last five calendar years, and less than 30% of the vote on its last submission if proposed three times within the preceding 5 calendar years, up from 3%, 6%, and 10%, respectively.
- increasing the minimum ownership requirements for shareholders to submit a shareholder proposal to 1% ownership of voting securities held for three years, which increases the existing requirement of $2,000 of voting securities held for one year; and
- permitting an issuer to exclude a shareholder proposal submitted by a person as a proxy, representative or on behalf of a shareholder.

These amendments would make it extremely difficult for shareholders to meet the requirements to submit shareholder proposals.

No Universal Ballot Rule

SEC is prohibited from adopting a rule, which it has proposed, that provides that a company must use a single ballot in connection with a contested election for its board of directors.

Ratings Agencies

CHOICE Act 2.0 would amend certain rules relating to nationally recognized statistical rating organizations ("NRSROs"):

- eliminate certain disclosure required by credit agencies describing the data and assumptions used in the determination of their published ratings;
- eliminate the requirement for NRSROs to receive an attestation on internal controls from its CEO;
- extend the look back period for conflicts with former employees of NRSROs to a one-year period prior to the departure of the employee rather than the one-year period preceding the date the credit rating action was taken;

- limits such conflicts to no longer apply to all underwriters, but rather just the lead underwriter; and
- permits an employee of an NRSRO that participates in sales and marketing to provide material information to a person determining the actual credit ratings.

Relief from the Sarbanes-Oxley Act 404(b) Requirement

The bill would eliminate the Sarbanes-Oxley Act requirement for an auditor attestation and the report on management's assessment of internal controls for companies with total market capitalization of less than $500 million or smaller banks with total market capitalization of less than $1 billion. The current threshold is $75 million.

PCAOB Changes

Additionally, the bill would implement certain changes affecting the PCAOB including making the PCAOB provide any information to Congressional committees as they may request, abolish the Investor Advisory Group and eliminate the use of funds collected from monetary penalties to fund merit scholarships.

Markets Structure – Consolidated Audit Trail

The bill would also prohibit the SEC from approving the consolidated audit trail national market system plan unless the operator of the consolidated audit trail plan has developed internal risk control mechanisms for the storage of market data and related academic research. The SEC has already approved the plan for the consolidated audit trail.

Department of Labor Fiduciary Rule

CHOICE Act 2.0 would repeal the Department of Labor's "fiduciary rule." The rule, which became applicable on June 9, 2017, subjects, for the first time, many of the investment and asset management recommendations from broker-dealers, banks and other financial organizations to retail retirement clients to ERISA's fiduciary standards and remedies.[4] Pursuant to a subsequent final rule published by the Department of Labor on May 22, 2017, full compliance with certain exemptions to the rule are scheduled to take effect in 2018.[5]

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[4] The fiduciary rule can be found at: http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28806. For a complete overview of the rule, you may wish to refer to our client publication: "The US Department of Labor's Final 'Fiduciary' Rule Incorporates Concessions to Financial Service Industry but Still Poses Key Challenges," available at: http://www.shearman.com/~/media/Files/NewsInsights/Publications/2016/04/The-US-Department-of-Labor-Final-Fiduciary-Rule-Incorporates-Concessions-to-Financial-Service-Industry-CGE-041416.pdf.

[5] For a discussion of the current status of the exemptions, and the DOL's approach to enforcement in the short-term, you may wish to refer to our client publication: "DOL Announces No Further Delay to Implementation of the 'Fiduciary Rule,'" available at: http://www.shearman.com/en/newsinsights/publications/2017/05/dol-no-delay-implementation-fiduciary-rule.

In addition to repealing the rule, CHOICE Act 2.0 would amend Section 913(g)(1) of the Dodd-Frank Act, which authorized, but did not require, the SEC to establish a uniform standard of care for broker-dealers and investment advisers. As amended by CHOICE Act 2.0, Section 913 of the Dodd-Frank Act would require the SEC, prior to promulgating such a rule, to report to Congress on whether:

- retail customers are being harmed because broker-dealers are held to a different standard of conduct than investment advisers;
- alternative remedies would reduce any confusion and harm to retail investors due to the different standards 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.

Accredited Investor Definition Modified

CHOICE Act 2.0 would amend the definition of accredited investor to match the tests of Regulation D by adjusting the income test to $200,000 per year (or $300,000 including spouse's income) and the net worth test to $1 million. These tests would be adjusted for inflation every five years. This amendment limits the SEC's ability to further modify these concepts through rule making. Furthermore, CHOICE Act 2.0 also expands the definition of accredited investor to include natural persons that are registered brokers, investment advisers and certain knowledgeable parties that have specific knowledge or experience relevant to a particular investment.

Recovery of Erroneously Awarded Compensation Policy

The Dodd-Frank Act requires the national securities exchanges and associations to prohibit the listing of any issuer that does not develop and implement a policy mandating that, in the event the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement, the issuer is to recover incentive-based compensation received by any current or former executive officer in the three-year period preceding the restatement that is in excess of what would have been paid under the restatement.[6] CHOICE Act 2.0 would limit the executive officers affected by the rule to those that had control or authority over the financial reporting that resulted in the accounting restatement.

[6] In July of 2015, the SEC issued a proposed rule implementing Section 954 of the Dodd-Frank Act. The proposed rule can be found at http://www.sec.gov/rules/proposed/2015/33-9861.pdf. For a complete overview of the proposed rule, you may wish to refer to our client publication: "SEC Proposed Highly Anticipated Clawback Rules," available at: http://www.shearman.com/~/media/Files/NewsInsights/Publications/2015/07/SEC-Proposes-Highly-Anticipated-Clawback-Rules-ECEB-070915.pdf.

Dodd-Frank Act Amendments and Repeals

The bill would repeal the following the Dodd-Frank Act rulemaking mandates directed to the SEC:

- the pay ratio disclosure rule (the rule requiring issuers to disclose the ratio between CEO pay and that of the median annual compensation of all employees);[7]
- the employee and director hedging disclosure rule;
- the authorization of the SEC to adopt proxy access rules;
- conflict minerals disclosure rule;
- resources extraction disclosure rule;
- mine safety disclosure rule;
- the interagency rulemaking to restrict incentive compensation at certain financial institutions; and
- the authorization to adopt rules related to CEO/Chairman split disclosures.

In addition, the bill would repeal, among others: (i) mandates to conduct various studies, (ii) the authority of the SEC to restrict mandatory pre-dispute arbitration, (iii) rules requiring disclosure by investment advisers on short sales, (iv) certain enforcement and penalty provisions relating to violations of securities laws by credit rating agencies, (v) the SEC's authority to require a national securities association registered under the Exchange Act to establish and account for a reasonable annual accounting support fee to adequately fund the annual budget of the Governmental Accounting Standards Board, and (vi) the SEC's rulemaking authority relating to the loan or borrowing of securities if such rule or regulation is appropriate in the public interest or for the protection of investors.

The bill would further eliminate the need for the Comptroller General of the United States and the GAO to conduct certain studies to determine the cost of compliance with various regulations including the accredited investor standard, custody rule costs, the feasibility of forming a self-regulatory organization to oversee private funds and short selling. It would also eliminate the requirement for an issuer of municipal securities to retain an advisor prior to issuing such securities.

Exemption of and Reporting by Private Equity Fund Advisers

CHOICE Act 2.0 would amend Section 203 of the Advisers Act by: (i) providing that no investment adviser shall be subject to registration/reporting requirements of the Advisers Act with respect to providing investment advice relating to a private equity

[7] For a complete overview of the final rule on pay ratio disclosure, you may wish to refer to our client publication: "The SEC's Final Pay Ratio Rules: What You Need to Know," available at: http://www.shearman.com/~/media/Files/NewsInsights/Publications/2015/08/The-SECs-Final-Pay-Ratio-Rules-What-You-Need-to-Know-ECEB-081015.pdf.

fund, and (ii) requiring that within 6 months after the legislation's enactment, the SEC must issue final rules to: (A) require investment advisers to private equity funds to maintain such records and provide such reports to the SEC as the SEC determines necessary to the public interest and for the protection of investors (taking into account fund size, governance, investment strategy, risk, and other factors) and (B) define the term "private equity fund" for purposes of this new subsection of the Advisers Act.

As background, the Dodd-Frank Act greatly expanded the number of private equity fund managers required to register as investment advisers. CHOICE Act 2.0 provisions summarized above seem poised to largely reverse this requirement, but the SEC's definition of "private equity fund" and the reporting and recordkeeping that would be required of unregistered private equity fund advisers will be critical to determining the true practical impact of this section of the Act.

Streamlining of Applications for an Exemption from the Investment Company Act of 1940

Section 6(c) of the '40 Act provides the SEC with the authority to grant orders exempting applicants from the provisions of the '40 Act, if the SEC finds it is in the public interest to do so. CHOICE Act 2.0 would require the SEC, within 5 days of the receipt of an exemptive application, to either: (i) publish the exemptive application, or (ii) if the SEC determines the application is deficient, to inform the applicant of the specific reasons why it was rejected. The bill would give the SEC 45 days after publication to evaluate an application (with a 45-day extension under certain circumstances). After the 45-day period, the SEC must either: (i) approve the application, (ii) if the application would have been approved if it had included additional information, inform the applicant of what information it needs to provide, or (iii) deny the application. If SEC were to deny an application, it must provide a written explanation and provide an opportunity for a hearing if requested by the applicant. Any such hearing would be required to be held within 30 days after the denial if requested by the applicant. If the SEC failed to meet its time limits for denial of an application or holding a hearing after a denial, the application would be automatically approved.

Records and Reports of Private Funds

Section 204(b) of Advisers Act (Records and Reports of Private Funds) and section 211(e) would be amended by CHOICE Act 2.0 to: (i) delete any mention of the FSOC, and (ii) remove the ability of the SEC to require information in order to assess systemic risk (leaving "the public interest" and "the protection of investors" as the only two considerations). These changes implicitly call into question the primary rationale for Form PF, an SEC filing requirement adopted in the wake of the financial crisis ostensibly to gather information from private funds for the purpose of assessing systemic risk (i.e., with the expectation that the SEC would share Form PF information with FSOC).

Changes to Swap and Security-Based Swap Rules

CHOICE Act 2.0 has only limited direct impact on the swaps and security-based swaps markets. It makes two key amendments: First, it calls for harmonization between swaps and security-based swaps rules issued under Title VII of the Dodd-Frank Act. Specifically, it requires the CFTC and SEC to review each rule, regulation, and any other regulatory guidance issued by the agencies under Title VII. In the event there is an inconsistency between the approaches of the two agencies, the SEC and CFTC must issue new rules, regulations, or other regulatory guidance to resolve the inconsistency.

Second, CHOICE Act 2.0 generally exempts from CFTC and SEC regulation swaps and security-based swaps between majority-owned affiliates that are consolidated from an accounting perspective. However, in the event either affiliate is a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant, the transaction must still comply with the reporting, risk management, and anti-evasion requirements. The change eliminates current requirements that many inter-affiliate swaps be reported and expands existing exemptions for such swaps from clearing, margin and other requirements.