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Treasury Issues Report Outlining Proposed Reforms to U.S. Capital Markets

On October 6, the U.S. Department of the Treasury issued the second of four reports (the "Report," available here, together with related press release and fact sheet) in response to President Trump's executive order signed on February 3 (see our client alert here) (the "Executive Order") setting forth "Core Principles" intended to guide the reform of the U.S. financial regulatory system. This second, 220-page report covers the U.S. capital markets. The first report addressed the U.S. depository system, covering banks, savings associations and credit unions (our related client alert is available here), and upcoming reports will cover the regulation of the asset management and insurance industries and nonbank financial institutions, financial technology and financial innovation.

The second report, like the first, echoes some of the regulatory reforms contained in the Financial CHOICE Act (the "CHOICE Act") (see our client alert here) passed by the House of Representatives in June 2017 and proposes the relaxation of various provisions of the Dodd-Frank Act addressing the regulation of the U.S. capital markets. As noted by Treasury Secretary Steven T. Mnuchin, "[t]he U.S. has experienced slow economic growth for far too long . . . . [b]y streamlining the regulatory system, we can make the U.S. capital markets a true source of economic growth which will harness American ingenuity and allow small businesses to grow." While some of the changes outlined in the Report would require congressional action, the overwhelming majority could be accomplished by revising existing rules, according to the Report, which would present fewer obstacles to implementation.

The Report addresses a broad range of issues regarding the regulation and functioning of the U.S. capital markets and is intended to be a road map for action by the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"). In addition to discussing issues regarding capital formation, the Report addresses regulatory structure and process, equity market structure, the Treasury market, securitization, derivatives, financial market utilities, and international aspects of capital market regulation, each discussed below.

Access to Capital

Key among the Report's various proposals are those aimed at encouraging and streamlining capital formation. SEC Chairman Jay Clayton has indicated his concern that the declining number of IPOs has made it more difficult for "Mr. and Mrs. 401(k)" to participate in the potentially lucrative investment opportunities available to investors in relatively early stage companies. The Report notes that, increasingly, companies have chosen to remain private until they have grown significantly past the point at which their predecessors would have gone public, despite recent regulatory initiatives such as the 2012 Jump-start Our Business Startups Act (the "JOBS Act"). Since 1990, the number of domestic public companies listed in the United States has declined by nearly 50%, reflecting a decrease in the number of private companies going public as well as an increase in the number of delistings (attributable to consolidation as well as business failures).

In response to this concern, the Report outlines the following proposals aimed at facilitating public offerings:

- ***Eliminate Non-Material Disclosure Requirements.*** The Report recommends eliminating disclosure requirements relating to conflict minerals (Section 1502 of Dodd-Frank), mine safety (Section 1503), resource extraction (Section 1504), and pay ratios (Section 953(b)) on the grounds that such information, according to Treasury, is not material to the reasonable investor. Absent legislative action to repeal those provisions, the Report recommends that the SEC consider exempting small reporting companies and emerging growth companies ("EGCs") from these requirements.

- ***Streamline Regulation S-K Requirements.*** The Report recommends that, as required by the Fixing America's Surface Transportation Act (the "FAST Act"), the SEC proceed to streamline Regulation S-K. On October 11, the SEC issued its proposal, available here.

- ***Permit Additional Pre-IPO Communications.*** Under the JOBS Act, EGCs may "test the waters" by communicating with qualified institutional buyers ("QIBs") and institutional accredited investors to determine, prior to undertaking the expense of preparing a registration statement, whether they might be interested in a contemplated securities offering. Given that the SEC now permits all companies to file for IPOs confidentially, the Report recommends that companies other than EGCs be allowed to "test the waters" with potential investors that are QIBs or institutional accredited investors.

- ***Shareholder Proposals.*** Rule 14a-8 under the Securities Exchange Act of 1934 (the "Exchange Act") allows a shareholder to have his or her proposal placed in a company's proxy materials if certain conditions are met. To be eligible under the rule, a shareholder must have held, for at least one year before the proposal is submitted, either (1) company securities with at least $2,000 in market value, or (2) at least 1% of the company's securities entitled to vote on the proposal. In order to promote greater accountability while reducing costs and burdens of shareholder proposals, Treasury recommends revisions to the $2,000 holding requirement (which was instituted over 30 years ago) and to the resubmission thresholds for repeat proposals.

- ***Proxy Advisory Firms.*** Public companies and their shareholders differ significantly in their views on proxy advisory firms, with companies, on the one hand, expressing concerns regarding the role such firms play in advising shareholders on how to vote their shares and related conflicts of interest, and shareholders, on the other, praising the advice provided by such firms. In light of such differing opinions and prior inconclusive government reports on the role of proxy advisory firms, the Report recommends further study and evaluation.

- ***Class Action Litigation.*** The Report recommends that the states and the SEC continue to investigate various means to reduce costs of securities litigation for issuers in a way that protects investors' rights and interests, *e.g.*, by use of arbitration.

- ***Shareholder Rights and Dual Class Stock.*** The Report notes that corporate governance and shareholders' rights are a matter of state law and that some companies have dual classes of common stock, where shareholders may have equal economic interests but different voting rights, allowing one class of vote holders (*e.g.*, the founders) to have control over all shareholder votes. Treasury recommends that the SEC continue its efforts, when reviewing company offering documents, to comment on whether the documents provide adequate disclosure of dual class stock and its effects on shareholder voting.

- ***Allow Business Development Companies to Use Securities Offering Reform.*** In 2005, the SEC adopted securities offering reform rules that modernized certain aspects of the registered offering process under the Securities Act. Many of these changes, such as safe harbor for factual business information and forward-looking statements and the "access equals delivery" model for delivery of prospectuses, did not apply to business development companies ("BDCs"). The Report recommends that the SEC revise the securities offering reform rules to include BDCs.

- ***Smaller Public Companies.*** The Report notes a variety of reasons for the substantial decline in the number of IPOs in the United States and its disproportionate impact on smaller companies, including the increased regulatory burdens facing smaller public companies (Treasury refers to one study that noted that IPOs by issuers with initial market capitalization of $75 million or less represented 38% of the number of IPOs in 1996, but only 6% in 2012, while IPOs by issuers with initial market capitalization of $700 million or more increased over the same period from 3% to over 33%). Recommendations aimed at easing these regulatory burdens include the following:

  - <u>Modify Eligibility Requirements for Scaled Regulation</u>. Treasury supports modifying rules that would broaden eligibility for status as a smaller reporting company and as a non-accelerated filer to include entities with up to $250 million in public float (up from the current limit of $75 million). Additionally, the Report recommends extending the eligibility for EGC status to up to 10 years (from the current five) subject to a revenue and/or public float threshold.

  - <u>Review Rules for Interval Funds</u>. Fund managers are restricted by SEC rules from investing in illiquid securities such as those of smaller public companies. To promote greater investment in smaller public companies and private companies with limited or no liquidity, the Report recommends that the SEC review its rules for "interval funds" (closed-end funds that periodically offer to repurchase their shares) to determine whether more flexible provisions might be enacted to encourage creation of close-end funds that can more easily invest in a broader range of issuers.

- Review and Consolidate Research Analyst Rules. In 2003 and 2004, 12 major broker-dealer firms entered into a settlement agreement with the SEC (the "Global Settlement") requiring them to reform their structures and practices to insulate research analysts from investment banking pressures in order to prevent conflicts of interest. While the Global Settlement only applies to the firms that are parties to the settlement, other broker-dealers are subject to general rules on research analyst reports that may differ from the Global Settlement terms. Treasury recommends a holistic review of the Global Settlement and the research analyst rules to determine which provisions should be retained, amended or removed, with the objective of harmonizing a single set of rules for all financial institutions.

- ***Expanding Access to Capital.*** The Report proposes various modifications to the "Regulation A+" and crowdfunding regimes (both established by the JOBS Act) intended to facilitate their usefulness to smaller issuers.

  - Increased Flexibility for Tier 2 of "Regulation A+". "Regulation A+," which amended Regulation A by creating two tiers of exempted small offerings, has enabled more companies to take advantage of the "mini IPO" process. Tier 2 offerings under "Regulation A+" permit companies to conduct offerings of up to $50 million in a 12-month period. Additionally, Tier 2 issuers may use a scaled disclosure offering document and "test the waters" with any investor prior to qualification of an offering statement. Treasury recommends expanding Regulation A+ eligibility to include Exchange Act reporting companies, requiring that state securities regulators update their regulations to exempt secondary trading of Tier 2 securities (failing which the SEC should use its authority to pre-empt state registration requirements for such transactions), and increasing the Tier 2 offering limit to $75 million.

  - Crowdfunding. The crowdfunding rules implementing Title III of the JOBS Act became effective in May 2016. According to the Report, in conversations with Treasury staff, market participants have expressed concerns about the cost and complexity of using crowdfunding compared to private placement offerings. Accordingly, Treasury recommends a number of modifications, including (1) allowing single-purpose crowdfunding vehicles advised by a registered investment adviser, (2) waiving the limitations on purchases in crowdfunding offerings for accredited investors as defined by Regulation D, (3) amending the crowdfunding rules to have investment limits based on the greater of annual income or net worth for the 5% and 10% tests, rather than the lesser, (4) modifying the conditional exemption from the registration requirements of Section 12(g) of the Exchange Act by raising the maximum revenue requirement from $25 million to

$100 million, and (5) increasing the limit on how much can be raised over a 12-month period from $1 million to $5 million.

- ***Maintaining the Efficacy of the Private Markets.*** The Report proposes a number of additional initiatives aimed at facilitating the operation of the private securities markets and improving access to private capital markets for small businesses:

  - Create Appropriate Regulatory Structure for Finders. The Report notes that it can be challenging for small businesses to raise amounts of capital below a level that would attract venture capital or a registered broker-dealer. Finders, individuals or firms that connect an issuer seeking to raise capital with an investor for a fee (particularly if it is a performance-based fee), operate in an uncertain regulatory environment. Treasury recommends that the SEC, FINRA and state securities regulators propose a new regulatory structure (along the lines of a "broker-dealer lite" rule) for finders and other intermediaries in capital-formation transactions.

  - Allow Additional Categories of Sophisticated Investors to Participate in Regulation D Offerings. Treasury recommends that the accredited investor definition be amended to expand the eligible pool of sophisticated investors. The "accredited investor" definition could be expanded to include, for example, any investor who is advised on the merits of making a Regulation D investment by a fiduciary, such as an SEC- or state-registered investment adviser. Furthermore, financial professionals, such as registered representatives and investment adviser representatives, who are considered qualified to recommend Regulation D investments to others, could also be included in the definition of "accredited investors."

  - Review Rules for Private Funds Investing in Private Offerings. The Report suggests that the ability to invest in a portfolio of privately placed securities could reduce investment risk. Treasury recommends a review of the provisions of the Securities Act as well as of the Investment Company Act of 1940 that restrict unaccredited investors from investing in private funds holding securities issued under Rule 506 of Regulation D.

  - Empower Investor Due Diligence Efforts**.** The Report notes that to effectively empower investors, government should ensure that the public has access to information to make informed investment decisions. However, information on "bad actors" is currently fragmented across databases maintained by different agencies and organizations. Treasury recommends that federal and state financial regulators, along with their counterparts in self-regulatory organizations ("SROs"), work to centralize reporting of individuals and firms that have been subject to adjudicated disciplinary proceedings or criminal convictions, which can be searched easily and efficiently by the investing public free of charge.

Regulatory Structure and Process

The U.S. capital markets regulatory system comprises two key regulators, the SEC and the CFTC, as well as state regulators and a number of SROs, which all play a role in ensuring proper functioning of the capital markets. To avoid regulatory fragmentation, overlap and duplication that may lead to ineffective regulatory oversight and costly inefficiencies, the Report recommends that the SEC and CFTC:

- Make their rulemaking processes more transparent and incorporate more robust economic analysis, greater consideration of the effects on small entities, and public input;
- Limit imposing substantive new requirements through guidance or no-action letters rather than through notice and comment rulemaking, while preserving the authority to provide exemptions to facilitate market innovation; and
- Conduct comprehensive reviews of the roles, responsibilities and capabilities of SROs under their respective jurisdictions and make recommendations for operational, structural and governance improvements of the SRO framework.

The Report also addresses the potential combination of the SEC and the CFTC but concludes that any efficiency gains would be minor and outweighed by a reduction in the regulators' effectiveness.

Equity Market Structure

Capital formation and economic growth require strong secondary markets. To foster more robust equity markets, the Report recommends:

- Aligning regulation to promote liquid and vibrant markets as an element of the President's Core Principles for Regulating the United States Financial System;
- Identifying the need for regulators to keep pace with market developments to support economic growth and the needs of consumers and businesses;
- Adjusting the current "one-size-fits-all" equity market structure for smaller companies that are currently experiencing limited liquidity for their shares; and
- Reducing market fragmentation to facilitate effective liquidity provision for the least liquid companies.

The Treasury Market

To improve protections for Treasury market (that is, the market for U.S. government securities), the Report recommends:

- Reducing regulatory data gaps in the Treasury market, particularly regarding principal trading firms, which remain despite recent efforts to improve transparency for Treasury and regulators; and
- Supporting further study and improvement of clearing and settlement arrangements by regulators, market participants and other stakeholders.

Securitization

To encourage high quality securitization, the Report recommends:

- Rationalizing the capital that a banking organization is required to hold against a securitization exposure when compared to the capital required to be held against the underlying assets;
- Adjusting bank liquidity standards to consider inclusion of senior securitizations with a track record of performance as high-quality liquid assets;
- Revising and expanding the underwriting criteria for certain assets that back securitizations in order to exempt the sponsors from risk retention requirements; and
- Reducing burdensome non-material disclosure requirements.

Derivatives

To recalibrate existing derivatives regulation, the Report recommends:

- Harmonizing SEC and CFTC rules through more appropriate capital and margin treatment for derivatives, allowing for innovation and flexibility in execution processes, and improving market infrastructure;
- Improving cross-border regulatory cooperation between the CFTC and the SEC with non-U.S. jurisdictions to minimize market fragmentation, redundancies, undue complexity and conflicts of law; and
- Promoting a level playing field for market participants while enabling healthy, fair and robust derivatives markets.

Financial Market Utilities

To improve oversight of clearinghouses and Financial Market Utilities ("FMUs"), the Report recommends:

- Addressing systemic risk management issues left unresolved by post-crisis regulation;
- Improving oversight of FMUs, including finalizing an appropriate regulatory framework for FMU recovery or resolution to avoid taxpayer-funded bailouts; and
- Continuing the study, by the appropriate regulatory agencies, of the evolving role these entities play in the financial system.

International Aspects of Capital Markets Regulation

The Report notes that, given the size and the global nature of the U.S. capital markets, cross-border cooperation and integration with other financial regulators plays a crucial role in enhancing market efficiency and stability. However, overlap, duplication and conflicts among various regulatory frameworks can negatively affect internationally active institutions and lead to market fragmentation, distortion of services and unnecessary costs. The Report cites, for example, the EU's Markets in Financial Instruments Directive II ("MiFID II"), which will apply across Europe from January 3, 2018 and which contains rules governing the EU's financial services sector, that has already presented a number of conflicting issues for U.S. financial services firms. In particular, U.S. asset advisers stand to be negatively affected by MiFID II's requirement for the unbundling of financial research services and payments. Currently, U.S. fund managers receive analyst research at no cost as investment banks and brokers bundle the cost into trading fees that are passed onto investors. Under MiFID II, fund managers will be required to pay directly for analyst research or create separate research payment accounts funded by clients. This requirement conflicts directly with U.S. regulations that prohibit U.S. brokers that are not registered as investment advisers from directly selling research to clients. The SEC and the European Commission are currently in talks to resolve this issue.

Keeping in mind the persistent need for international financial regulatory cooperation to ensure stability and coherence in the complex and diverse global markets, the Report recommends that:

- U.S. regulators and Treasury sustain and develop technical level dialogues with key international partners to address conflicting or duplicative regulation;
- U.S. regulators seek to reach outcome-based, non-discriminatory substituted compliance arrangements with other regulators designed to counteract the effect of regulatory redundancy and conflict;

- U.S. agencies continue to regularly coordinate their policy before as well as after international engagements to promote effectiveness and efficiency of regulations;
- U.S. members of standard setting bodies continue to advocate for and shape international regulatory standards in an effort to promote vibrant financial markets free from unnecessary regulatory standard-setting or conflicting cross-sectoral standards; and
- Treasury and U.S. agencies engage to elevate the quality of stakeholder consultation and input globally.

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Although any legislative changes to the Dodd-Frank Act would need at least limited bipartisan support, the majority of the changes proposed in the Report could be effected through the regulatory process alone. Importantly, however, regulatory changes made by the SEC and CFTC would often be subject to complex and time-consuming processes, including notice-and-comment rulemakings and interagency coordination.

We will continue to provide updates on these reports and related regulatory changes as the situation develops.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Mark S. Bergman +44-20-7367-1601 mbergman@paulweiss.com	Andrew J. Foley +1-212-373-3078 afoley@paulweiss.com	Roberto J. Gonzalez +1-202-223-7316 rgonzalez@paulweiss.com
David S. Huntington +1-212-373-3124 dhuntington@paulweiss.com	Raphael M. Russo +1-212-373-3309 rrusso@paulweiss.com	Hank Michael +1-212-373-3892 hmichael@paulweiss.com

Securities Practice Management Attorney Monika G. Kislowska contributed to this Client Memorandum.