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Treasury Issues Report on Capital Markets

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On Friday, October 6, the Treasury Department issued a report to the President on streamlining and reforming U.S. capital market regulation. The report covers recommendations on nine topics across the U.S. financial regulatory system. One of the topics – Access to Capital – includes many recommendations of interest to participants in public and private company capital markets. Without dwelling on why Treasury would issue such a report on the Friday before a holiday weekend, let's dive into the substance of this section of the report.

The report starts with frequently cited statistics chronicling the decline in the number of listed companies and IPOs over the past 20 years. The report posits that fewer investment opportunities in the public markets may "unintentionally exacerbat[e] wealth inequality" because private investment opportunities are limited to high income and high net worth investors. Although the report reaches no conclusions on the cause of the decline, it does offer observations gleaned from outreach to stakeholders during preparation of the report. The reasons cited include compliance costs, changing equity market structure, nonfinancial disclosure requirements aimed at social or political goals, shareholder litigation risk, short termism, inadequate oversight of proxy advisory firms and lack of research coverage for smaller companies. After praising the success of the JOBS Act, the report launches into a series of recommendations.

Recommendations

Remove Non-Material Disclosure Requirements. The report recommends the repeal of four provisions of the Dodd-Frank Act and related SEC rulemaking – disclosure of conflict minerals, mine safety, payments by resource extraction issuers and CEO pay ratio – that it says were "well-intentioned" but not appropriate areas for regulation by the federal securities laws.

Eliminate Duplicative Requirements. The report recommends that the SEC amend Regulation S-K to eliminate provisions that are duplicative, overlapping, outdated or unnecessary. Last year the SEC prepared a report required by the FAST Act with recommendations on simplifying and modernizing disclosure, and the Treasury report encourages the SEC to proceed with a rulemaking proposal to implement these recommendations (which the SEC has conveniently scheduled for an open meeting on Wednesday, October 11). The report also urges the SEC to proceed with the proposal it issued in August 2016 that would remove SEC disclosure requirements that duplicate financial statement disclosures already required under U.S. GAAP.

Permit Additional Pre-IPO Communications. The ability for emerging growth companies (EGCs) to have "testing the waters" meetings with qualified institutional buyers and institutional accredited investors has been a popular feature of the JOBS Act. The report urges that all IPO candidates be permitted to test the waters. Although the JOBS Act added this provision to Section 5 of the Securities Act of 1933, extending it to companies other than EGCs is within the SEC's rulemaking authority.

Address Concerns on Shareholder Proposals. The recommendations on this topic are less extensive than the calls for reform that have come from the business community. The report acknowledges that, although companies have asserted that the aggregate costs of complying with Rule 14a-8 run in the tens of millions of dollars plus management time, many investors believe that the rule is a key right that has been important in promoting many corporate best

practices. The report recommends that the holding requirement threshold of $2,000 of stock ownership necessary to include a proposal be "substantially revised," without indicating the appropriate threshold. In an "out-of-the-box" observation, it suggests that the SEC explore setting an eligibility threshold as a percentage of a proponent's liquid net assets, although it is not clear from the report whether higher or lower would be better. In addition, the report repeats the frequently made suggestion that the resubmission thresholds be increased substantially, although here again it does not propose alternative thresholds.

Shareholder Rights and Dual Class Stock. The report acknowledges the current debate between companies and investors on the propriety of dual class stock but does not choose sides. The report does, however, identify the issue as one of state corporate law and recommends that the SEC focus its efforts in this area on making sure that disclosure to investors about the effects of dual class stock on stockholder voting is adequate.

Modify Eligibility Requirements for Scaled Regulation. The report notes that the burdens of regulation fall disproportionately on smaller companies. To address this concern, it recommends that the threshold for smaller reporting company (SRC) status and non-accelerated filer status be increased from the current $75 million to $250 million, consistent in part with an SEC proposal issued last year to which the report cites. The SEC proposal, however, only addressed SRC status for purposes of scaled disclosure, expressly noting that changing the threshold for non-accelerated filers would bring with it an exemption from the attestation requirements of Sarbanes-Oxley Section 404(b) affecting internal control over financial reporting. The exemption from that requirement is likely to be more contentious than simply providing scaled disclosure for SRCs. The report also recommends extending EGC status for up to 10 years, consistent with a House bill that would preserve EGC status for companies with less than $50 million in annual revenues.

Review and Consolidate Research Analyst Rules. In outreach to smaller companies, Treasury heard that sell-side research on these companies has become sparse, due in part to increased costs arising from the 2003/2004 Global Settlement with 12 major investment banks that restricted the interactions research analysts could have within the firm and externally. Although the report has no specific recommendations to address this topic, it recommends a "holistic" review of the Global Settlement so that there is a single set of harmonized rules.

Increase Flexibility for Regulation A Tier 2. The report recommends that Regulation A Tier 2 be expanded to allow Exchange Act reporting companies to enjoy the benefit of the streamlined disclosure requirements. This change would have the effect of removing the restrictions in Form S-3 that apply to SRCs conducting primary shelf offerings. In addition, to increase the liquidity potential for Regulation A Tier 2 securities, the report recommends that either the states or the SEC create an exemption from registration for secondary transactions in these securities. Finally, the report recommends that the annual $50 million fundraising limit for Regulation A be increased to $75 million.

Other Capital Raising Recommendations. The report has recommendations for changes to crowdfunding, including allowing single-purpose investment vehicles advised by a registered investment adviser, waiver of investment limitations for accredited investors, and an increase in the annual limit from $1 million to $5 million. There is a discussion suggesting that equity crowdfunding may be an innovative tool that could broaden access to capital by female entrepreneurs. The report also focuses on intermediaries, urging the SEC, FINRA and the states to come up with a broker-dealer "lite" regulatory scheme for finders who help smaller companies raise money. Further, it recommends expanding the accredited investor definition and exploring ways for unaccredited investors to invest in pooled vehicles that invest in private placements.

Proxy Advisory Firms. Although the report makes no specific recommendations on proxy advisory firms, it includes a discussion describing the lack of transparency that concerns public companies while at the same time acknowledging the views of many shareholders who pay for the advice and find it valuable. The discussion does not

add significantly to the debate. The report recommends "further study and evaluation of proxy advisory firms, including regulatory responses to promote free market principles if appropriate."

The Takeaway?

The recommendations for increasing access to capital are familiar to those who have been following this area. Many, if not all, have been the subject of proposed legislation, proposed rulemaking or trade association recommendations. The SEC has the rulemaking authority in virtually all instances to implement these recommendations. Although Chairman Clayton is likely to incorporate many of these suggestions in his capital formation agenda, it will be interesting to see how much the SEC pursues prior to the Senate acting on the two SEC nominees, after which there will once again be a full Commission.

As notable as what was included in the recommendations is what was not included. For example, although a few of the Financial CHOICE Act (H.R. 10) provisions repealing Dodd-Frank rules were addressed, there was no mention of say on pay, clawbacks, hedging, exemptions from XBRL or the authority to issue rules on proxy access, all of which the CHOICE Act addressed. The discussion of proxy advisory firms was quite measured compared to the extensive regulatory structure that the CHOICE Act would impose on them. Similarly, the recommendations on shareholder proposals under Rule 14a-8 were mild compared to both the CHOICE Act and the recommendations of business groups. The CHOICE Act, which passed the House in a partisan vote, appears to be stalled in the Senate. This report may provide the basis for developing a proposal on which both the House and the Senate can agree.