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Legal Update
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US Financial CHOICE Act: An Update

In February 2017, US Representative Jeb Hensarling (R-Texas), chair of the House Financial Services Committee, penned a memorandum ("February Memo") directed to the Financial Services Committee Leadership Team that outlines proposed changes to a new version of the Financial CHOICE Act (yet to be introduced in this congressional session), which seeks to modify certain aspects of the Dodd-Frank Act and other financial regulations. Chairman Hensarling sponsored last year's version of the CHOICE Act. The 2016 version was formally introduced in September 2016, and although it cleared the House Financial Services Committee in 2016, it was never brought before the full House for a vote (and no companion legislation was introduced in the Senate).

Also in February, President Donald Trump issued an executive order that lays out certain "core principles" for the regulation of the US financial system ("Order"). The Order also directs the Treasury Secretary to consult with the heads of the member agencies of the Financial Stability Oversight Council and report to President Trump within 120 days (and periodically thereafter) regarding whether and to what extent existing laws and regulations promote the core principles. According to Chairman Hensarling, the Order "closely mirrors" the provisions in the CHOICE Act.[1]

According to the February Memo, the new version of the CHOICE Act would include a number of modifications to the 2016 version, including modifications related to the US Securities and Exchange Commission ("SEC"), as well as to registered advisers and registered and unregistered funds. Certain of these modifications are described below.

Wells Committee 2.0

According to the February Memo, the new version of the CHOICE Act would require the SEC to establish a "Wells Committee 2.0" to reevaluate the SEC's enforcement program. This proposal is likely a reference to the SEC's first Advisory Committee on Enforcement Policies and Practices which was created in 1972. That committee, which became known as the Wells Committee, was charged with "taking a fresh overall look at the Commission's enforcement program and to recommend to the Commission possible changes or refinements that . . . would represent further improvement."[2] As part of its work, the Wells Committee considered the SEC's enforcement practices and procedures to determine whether fairness to private parties subject to SEC rules or involved in SEC investigations and proceedings could be enhanced consistent with the need for effective enforcement.[3] The Wells Committee made 43 recommendations designed to improve the SEC's enforcement program, including that the SEC implement the practice of affording individuals and firms facing a possible SEC civil action an opportunity to explain why the action should not be brought – a recommendation that formed the basis of the SEC's current Wells Notice process.[4]

A Wells Committee 2.0 would likely have a similar mandate to the first Advisory Committee on Enforcement Policies and Practices. The issues that could be considered by a Wells Committee 2.0 may include the SEC's increased use of administrative proceedings, the substantial disparities between the time to prepare and scope of discovery in federal court actions governed by the Federal Rules of Civil Procedure and the much more limited time to prepare and scope of discovery provided to respondents in administrative proceedings governed by the SEC Rules of Practice, and the SEC Commissioners' delegation to the Enforcement Division's senior management of authority to open formal investigations.

Co-Conspirators under the Whistleblower Program

The new version of the CHOICE Act would prohibit a co-conspirator from receiving a reward under the SEC whistleblower program. This proposal is likely to be cause for concern in the SEC Division of Enforcement and Office of the Whistleblower. Although whistleblowers convicted of crimes arising from the same operative facts as an SEC action are ineligible for monetary rewards,[5] the SEC whistleblower program permits co-conspirators who are not criminally charged to receive rewards in some cases. It appears that the SEC has even paid at least one reward to a co-conspirator who was charged in a SEC civil enforcement action.

The SEC is willing to reward whistleblowers who are co-conspirators because it believes co-conspirators frequently make the best whistleblowers. In the SEC's view, they tend to be the most knowledgeable about the wrongdoing at issue and in the best position to identify those engaged in more egregious conduct. The SEC explained in the adopting release for the whistleblower rules that: "the original federal whistleblower statute – the False Claims Act – was premised on the notion that one effective way to bring about justice is to use a rogue to catch a rogue. This basic law enforcement principal is especially true for sophisticated securities fraud schemes which can be difficult for law enforcement authorities to detect and prosecute without insider information and assistance from participants in the scheme or their coconspirators." [6] It is important to note, however, that although it may reward co-conspirator whistleblowers in appropriate circumstances, the SEC also considers a whistleblower's role in the securities violation when determining the amount of a reward. Thus, there is no guarantee that a co-conspirator who "blows the whistle" will receive any award at all. Moreover, a co-conspirator who receives a reward does not necessarily receive any protection or immunity from an SEC enforcement action based on his role in the violation.[7] In fact, it appears that the SEC has offset a reward to a co-conspirator whistleblower against disgorgement, prejudgment interest, and penalty amounts assessed against that whistleblower for his own violations.[8]

If Chairman Hensarling's proposed changes to the CHOICE Act are adopted, the SEC will still have a tool to incentivize co-conspirators to report misconduct to the agency. The SEC's cooperation program is specifically designed to encourage co-conspirators to come forward. Under the SEC cooperation program, a co-conspirator who reports information about potential wrongdoing and cooperates fully in any resulting investigation or enforcement action may receive leniency up to and including non-prosecution by the SEC.[9] Even if they cannot receive a monetary reward, such co-conspirator whistleblowers may still wish to come forward in hope of obtaining leniency including a determination of no action, reduced charges, or smaller sanctions.

Amendment to Section 36(b) of the Investment Company Act of 1940 ("ICA")

The new version of the CHOICE Act would amend ICA Section 36(b) to require that a private action brought against an investment company for breach of fiduciary duty be "[stated] with particularity and meet the burden of clear and convincing evidence". It appears that this is an effort to make clear that breach of fiduciary duty claims should be treated like fraud claims by courts. Under federal civil procedure rules, fraud claims must be pled with particularity. Under fairly uniform state court standards, to successfully prove fraud, a plaintiff is required to meet a clear and convincing evidence standard (rather than a preponderance standard that applies generally to civil claims). Breach of fiduciary duty claims are sometimes but not always treated as fraud claims. Such a heightened pleading standard and burden of proof will generally make it more difficult for a plaintiff to sustain breach of fiduciary duty claims against officers, directors or other specified fiduciaries of the investment company.

Other Changes

According to the February Memo, the new version of the CHOICE Act also would:

- Prohibit "any SEC rulemaking by enforcement." Over the years, industry participants have criticized the SEC for doing just that.
- Allow the SEC to implement a conditional approval process for new securities products. Although the details are unclear, given the goals of the 2016 version of the CHOICE Act and those of the new administration, such a process might be used to expedite approvals related to new products (whether through registration statement effectiveness or exemptive applications).
- Eliminate the annual verification of accredited investor status, which, according to the February Memo, was "added by the SEC without Congressional consent" when implementing the JOBS Act.
- Require the US Department of Labor ("DOL"), in adopting any fiduciary rule, to adhere to a substantially similar standard after the SEC has promulgated its uniform fiduciary duty standard under the Dodd-Frank Act. In the meantime, however, the DOL has filed a notice proposing to delay the start of the fiduciary rule from April 10 to June 9, 2017.
- Require the SEC to either make permanent or end pilot programs that have been in existence for at least five years.
- Increase Section 3(c)(1)'s investor threshold from 100 to 500 for certain venture capital funds (referred to as "qualified angel funds" in the February Memo).

Last year's version of the CHOICE Act would have, among other things: repealed the "Volcker Rule"; required the SEC to exempt certain private fund advisers from registration and reporting; amended ICA Section 3(c)(1) to allow certain venture capital funds beneficially owned by no more than 250 persons (rather than 100) to rely on Section 3(c)(1); modified certain BDC requirements under the ICA; required the SEC to submit annual reports to Congress on enforcement priorities; required the SEC to publish its enforcement manual; allowed a respondent in an SEC administrative proceeding to require that the SEC terminate the administrative proceeding (and would have authorized the SEC to bring a civil court action instead); eliminated the SEC's authority to impose D&O bars; included enhanced penalties for financial fraud and self-dealing; required an SEC process for closing investigations on a timely basis; provided SEC investigation targets with access to SEC Commissioners at the Wells process stage; removed the Financial Stability Oversight Council's authority to designate non-

bank financial institutions and financial market utilities as "systemically important"; repealed the DOL's fiduciary rule; modified Reg. D regarding general solicitations, advertising, and accredited investor threshold increases; and removed risk retention for commercial mortgage securitizations.

We will be following, with great interest, any movement on the anticipated 2017 version of the CHOICE Act, as well as any related activities in Washington DC.

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Endnotes

[1] *See* Press Release, House Financial Services Committee, President's Executive Action Mirrors Financial CHOICE Act (Feb. 3, 2017), *available at* http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=401457. More recently, in response to President Trump's meeting with community bankers to discuss the difficulties they have faced under the Dodd-Frank Act, Chairman Hensarling issued a press release, which included the following statement:

> Republicans on the Financial Services Committee are eager to work with the President and his administration this year to fulfill the pledge to dismantle Dodd-Frank and unclog the arteries of our financial system so the lifeblood of capital can flow more freely and create jobs. The Financial CHOICE Act, our bold and forward looking plan, replaces Dodd-Frank with new policies to protect consumers by holding Wall Street and Washington accountable, end bailouts and unleash America's economic potential.

Press Release, Rep. Jeb Hensarling, Chairman, House Financial Services Committee, Hensarling Statement on President Trump's Meeting with Community Bankers (Mar. 9, 2017), *available at* http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=401578.

[2] *See* SEC, Report of the Advisory Committee on Enforcement Policies and Practices, at 1 (1972).

[3] *Id.* at 3.

[4] *Id.* at ii-viii.

[5] 17 CFR § 240.21F-8(c)(3).

[6] Securities Whistleblower Incentives and Protections, 76 Fed. Reg. 34300, 34350 (May 25, 2011).

[7] 17 CFR § 240.21F-15.

[8] *See In re* Whistleblower Award Proceeding, Release No. 34-77530 (Apr. 5, 2016), *available at* https://www.sec.gov/rules/other/2016/34-77530.pdf.

[9] *See* Policy Statement Concerning Cooperation by Individuals in Its Investigations and Related Enforcement Actions, 75 Fed. Reg. 3122 (Jan. 13, 2010) (issuing the policy statement on cooperation); *see also* 17 CFR § 202.12 (the policy statement).

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