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SEC Proposes Amendments to Exchange Act Rules—Higher Thresholds for Mandatory Registration as Required by the JOBS Act

On December 18, 2014, the SEC proposed rule amendments required by the Jumpstart Our Business Startups (JOBS) Act that, if enacted, would:

- revise the SEC's rules relating to the thresholds for registration, termination of registration and suspension of reporting to match the thresholds set forth in Section 12(g) and Section 15(d) of the Exchange Act as they were amended by the JOBS Act;
- provide guidance on how a company can determine which of its shareholders is an "accredited investor" for purposes of the amended thresholds; and
- amend the definition of "held of record" to exclude securities held by persons who received them under an "employee compensation plan" and create a related safe harbor.[1]

The SEC is seeking public comment on the proposed rule amendments for 60 days following their publication in the Federal Register.

Practical Implications

The SEC's proposals are summarized in detail below. Key practical implications for companies are as follows:

- In large part, the proposed amendments merely align the SEC's rules with the changes effected by the JOBS Act and provide guidance on their implementation. Nevertheless, the guidance on implementation, if adopted, will require private companies with securities registered under the Exchange Act to implement certain procedures that they may not currently have in place.
- Exchange Act Section 12(g), as amended by the JOBS Act, requires a company to register a class of its equity securities with the SEC if, at the end of its fiscal year, it has at least US$10 million in assets and a class of equity securities "held of record" by either (i) 2,000 persons or (ii) 500 persons who are not "accredited investors." The SEC's proposal aligns the asset and holder of record thresholds in Rule 12g-1 that includes the general Exchange Act registration requirements with the corresponding thresholds in Section 12(g).

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1 The proposed amendments are contained in SEC Release No. 33-9693, which can be found at this link.

- In the proposal, the SEC notes that without guidance from it, companies relying on having fewer than 500 non-accredited investors would likely use procedures similar to those used in Regulation D private placements under Securities Act Rule 506 when making the fiscal year-end determination of accredited investor status. However, even though the SEC has provided a non-exclusive and non-mandatory list of documents that a company can review to make this determination, the need for companies to take reasonable steps to verify accredited investor status in connection with these private placements has still created uncertainty as to whether the "reasonable" standard has been met. This proposal for the Exchange Act determination does not resolve this issue as it does not include a safe harbor that would provide a company with certainty on how to conclusively establish that an equity security holder is an accredited investor.

- The proposed rule amendments do, however, clarify that a company relying on having fewer than 500 non-accredited investors would need to determine as of the last day of each fiscal year whether it could reasonably rely on determinations previously made regarding accredited investor status (e.g., at the time of an investment in the company's securities) or whether facts and circumstances require a new determination to be made. If a new determination is necessary, under the proposed rule amendments, a mere representation from the putative accredited investor will generally not be sufficient on its own and other supporting documentation as to income or assets will likely be required. The ability to obtain such documentation and any required representations on a timely basis may be critical to companies that are close to the 500-holder threshold. Companies will therefore need to consider appropriate steps, such as incorporating into their agreements with investors a requirement that such information is provided annually.

- The JOBS Act effectively excludes from counting towards the 500-person accredited investor threshold or the 2,000-person threshold the underlying securities issued upon the exercise of compensatory options as well as any other awards of such securities. The JOBS Act does not, however, clarify whether transferees of such securities should be included. The proposed rule amendments, if adopted, clarify that transferees will not be covered by the exclusion (other than family members of the original grantees who acquire securities through gift or domestic relations order). As a result, to mitigate the risk of exceeding the Exchange Act registration thresholds, private companies that have issued securities pursuant to an employee compensation plan will need to amend their record-keeping procedures so as to carefully track when and to whom a person that received securities under an employee compensation plan transfers such securities.

- A foreign private issuer with holders of record of securities resident in the United States needs to determine the number of such holders in order to assess whether it is required to register under Section 12(g) of the Exchange Act. This is because, under Exchange Act Rule 12g3-2(a), even if a foreign private issuer exceeds the asset and total record holder thresholds of Section 12(g), it is exempt from registering any class of securities under Section 12(g) if the class of securities is held by fewer than 300 holders resident in the United States. Under the proposed rule amendments, when calculating holders of record, a foreign private issuer would be able to exclude securities received pursuant to an employee compensation plan when making its determination of the number of US resident holders under Rule 12g3-2(a). This amendment is helpful to a foreign private issuer that relies on Rule 12g3-2(a) and has employee compensation plans that cover its US resident employees. However, the proposal does not amend the existing requirement that securities held by employees need to be counted when a foreign company determines the percentage of its outstanding securities held by US residents in order to determine in the first place whether it is a foreign private issuer. This means that if a foreign company wants to maintain its status as a foreign private issuer, which requires, among other things, that no more than 50% of its outstanding voting securities are held of record by US residents, and to avail itself of the benefits of foreign private issuer status, it will need to continue to closely monitor its employee compensation plans to avoid inadvertently exceeding the 50% threshold as a result of securities issued to US resident employees.

The Proposed Amendments

Background

The JOBS Act was enacted in 2012 with the aim of expanding and easing methods of capital raising by private companies and reducing their regulatory obligations.

A major component of the JOBS Act was a set of measures relating to registration under the Exchange Act designed to permit private companies with growing numbers of shareholders to delay or avoid Exchange Act registration. Registration effectively turns a company into a "public company" and subjects the company, and its directors, officers and certain of its shareholders to a range of reporting and other obligations. The JOBS Act included amendments to Section 12(g) of the Exchange Act, which sets forth the requirements to register a class of equity securities of a company, and related sections of the Exchange Act.

Increased Numerical Thresholds

To align its rules with the changes made to the Exchange Act pursuant to the JOBS Act, the SEC is proposing certain amendments to rules related to the thresholds for registration, termination of registration and suspension of reporting under Section 12(g) and Section 15(d) of the Exchange Act. More specifically, the SEC proposes to amend Exchange Act Rules 12g-1 through 4 and Rule 12h-3 to reflect these new JOBS Act thresholds.

Increased Numerical Thresholds Applicable to Companies Generally

Prior to the JOBS Act, a company was required under Exchange Act Section 12(g) to register a class of its equity securities with the SEC if, at the end of the company's fiscal year, it had assets of US$10 million and the securities were "held of record" by 500 persons. As amended by the JOBS Act, Section 12(g) requires registration if, at the end of its fiscal year, a company other than a bank or a bank holding company has at least US$10 million in assets and a class of equity securities "held of record" by either (i) 2,000 persons or (ii) 500 persons who are not "accredited investors." The proposal aligns the asset and holder of record thresholds in Rule 12g-1 that includes the general Exchange Act registration requirements with the corresponding thresholds in Section 12(g). The proposed rule amendments do not change the general threshold applicable to termination of registration or the suspension of the duty to file reports with the SEC, which will remain at 300 record holders.

Application of the Increased Numerical Thresholds to Accredited Investors

As discussed above, a company relying on having fewer than 500 non-accredited investors will need to be able to determine which of its record holders are accredited investors. Instead of creating a new definition of accredited investor, the SEC is proposing that, when making this determination, a company apply the definition of accredited investor in Securities Act Rule 501(a) (i.e., the definition used for private placements conducted pursuant to Regulation D).

Companies conducting offerings in reliance on an exemption from Securities Act registration, such as Regulation D private placements, in which purchasers must be accredited investors, take various measures, including determining an investor's income or net worth or obtaining third-party certifications, to establish a reasonable belief that a prospective investor is an accredited investor. After a company completes its offering and has sold securities to purchasers who have been determined to be accredited investors, it is not required to periodically assess any purchaser's continued status as an accredited investor. In contrast, to determine whether its equity securities are required to be registered under Exchange Act Section 12(g), a company would under the SEC's proposal need to determine the accredited investor status of its equity security holders as of the last day of each fiscal year.

In the proposal, the SEC notes that without guidance from it, companies would likely use procedures similar to those used in Regulation D private placements under Securities Act Rule 506 when making the fiscal year-end determination of whether an equity security holder is an accredited investor. The SEC notes that it is not providing for a blanket safe harbor pursuant to which a company could rely on information gathered during a prior offering of its securities, such as an offering in reliance on Rule 506, on the assumption that such reliance could result in the use of outdated information that may no longer be reliable. Instead, according to the proposal, a company will need to determine, based on facts and circumstances, (i) if it can rely upon prior information to form a reasonable basis for believing that the security holder continues to be an accredited investor as of the last day of the fiscal year or (ii) whether it will need to carry out additional due diligence on the investor status of its equity security holders.

The SEC recognizes the potential challenges of the proposed approach, including those resulting from the difference in making the determination under the Securities Act, which is in the context of an investment decision at the time of an offering, and under the Exchange Act, which is for the purpose of periodically determining registration obligations. The SEC notes that it is therefore considering whether a different approach to that used under Rule 506 would be appropriate for determining Exchange Act registration obligations. The SEC is also seeking public comment on:

- whether it should provide a safe harbor, such as a prescribed process, or additional guidance on how to establish and update a reasonable belief that a security holder is an accredited investor and therefore qualifies under the definition; and
- if the new rules were to include a safe harbor or other guidance, what type of certifications or determinations a company would be permitted to rely on to satisfy the reasonable belief requirement—examples mentioned by the SEC in the proposal include annual affirmation of accredited investor status by an investor, other information obtained by the company or a combination of a certification and other information, or permitting the company to rely on a third-party certification for determining the accredited investor status of an investor.

The accredited investor provisions in Rule 506 have resulted in fewer than expected transactions using Rule 506(c). One of the problems has been the need for companies to take reasonable steps to verify accredited investor status. Even though the SEC has provided a non-exclusive and non-mandatory list of documents that a company can review to determine accredited investor status, the use of this "reasonable" standard has still created uncertainty as to whether the standard has been met. This proposal for the Exchange Act determination does not resolve this issue as it does not include a safe harbor that would provide a company with certainty on how to conclusively establish that an equity security holder is an accredited investor. Given the generality of the proposal and the resulting potential compliance issues related to the accredited investor threshold, we expect commentators to ask the SEC to provide additional guidance on how a company should determine the accredited investor status of its equity security holders.

Amendments to Numerical Thresholds Applicable to Banks and Bank Holding Companies

The SEC is proposing that the holder of record thresholds for Exchange Act registration with respect to banks and bank holding companies in Rule 12g-1 be raised to 2,000 holders. The record holder threshold in Exchange Act Rules 12g-2 and 12g-3 that govern the termination of registration and suspension of reporting would be increased for banks and bank holding companies from 300 holders to 1,200 holders. Exchange Act Rule 12g-4 and Rule 12h-3 that permit the immediate suspension of the duty to file periodic and current reports are also being updated to reflect the new 1,200-holder threshold for banks and bank holding companies. These changes would set forth procedural accommodations allowing banks and bank holding companies to suspend reporting immediately rather than wait the prescribed 90 days or until the end of the reporting year, and to terminate their registration at the higher 1,200-holder threshold as opposed to the old 300-holder threshold. This is currently not possible since, as discussed above, the higher threshold is not reflected in Rule 12g-4 and in Rule 12h-3 that permit the immediate suspension of the duty to file reports under Exchange Act Sections 13(a) and 15(d), respectively.[2]

Definition of Holders of Record

To implement the mandates of the JOBS Act, the SEC is proposing to amend the definition of "held of record" that will be used when determining whether a company is required to register a class of equity securities under Exchange Act Section 12(g)(1). Under the proposal, a company could exclude in this determination securities that are held by persons who received the securities pursuant to an employee compensation plan.[3] Instead of creating a new definition for the term "employee compensation plan," the SEC proposal relies on the current definition of "compensatory benefit plan" and the conditions for exemption from Securities Act registration set forth in Exchange Act Rule 701(c).[4] The SEC notes that relying on an existing definition that is already understood by market participants makes it easier for companies to avail themselves of this safe harbor.

The proposal would permit a company to exclude securities that:

- are held by persons eligible to receive securities from the company pursuant to Securities Act Rule 701(c), including employees, directors, general partners, trustees, officers and certain consultants and advisors; or
- were acquired by such persons in exchange for securities excludable under the amended definition of "held of record."

The latter exclusion aims to facilitate the ability of a company to conduct restructurings, business combinations and similar transactions that are exempt from Securities Act registration. Under the proposal, if the securities being surrendered in such a transaction would not have been counted under the proposed definition of "held of record," the securities issued in the exchange

2 In connection with these changes, the SEC is also proposing to revise its rules related to record holder thresholds so that savings and loan holding companies are treated in a similar manner to banks and bank holding companies for the purposes of registration, termination of registration, or suspension of their Exchange Act reporting obligations. Even after the enactment of the JOBS Act, savings and loan holding companies have continued to be subject to the old 500-holder threshold for registration and 300-holder threshold for the termination of registration and suspension of reporting. The SEC proposes changing these thresholds for savings and loan holding companies to 2,000 holders and 1,200 holders, respectively.

3 It should be noted that stock options issued pursuant to an employee compensation plan are exempt from registration under the Exchange Act pursuant to Rules 12h-1(f) and (g) irrespective of the number of holders of such options. In addition, the SEC has similarly exempted restricted stock units (RSUs) from such registration requirement pursuant to a global no-action letter (see *Fenwick & West LLP* (February 13, 2012)). These exemptions do not apply to the underlying securities issuable upon exercise of options or settlement of RSUs. The provision of the JOBS Act and the amendments proposed by the SEC that are the subject of this memorandum provide such an exemption for the underlying securities under certain circumstances.

4 "Compensatory benefit plan" is defined in Rule 701(c) as any purchase, savings, option, bonus, stock appreciation, profit sharing, thrift, incentive, deferred compensation, pension or similar plan. The conditions for exemption set forth in Rule 701(c) include the requirements that the plan be in writing and that the plan be established by the issuer, its parents, its majority-owned subsidiaries or the majority-owned subsidiaries of the issuer's parent, for the participation of their employees, directors, general partners, trustees, officers and certain consultants and advisors, and their family members who acquire securities through gift or domestic relations order.

also would not be counted under this definition. The securities issued in the exchange would be deemed to have a compensatory purpose because they would replace other securities previously issued pursuant to an employee compensation plan.

The proposal clarifies that a company that is determining whether it is required to register a class of its equity securities may, when calculating the number of holders of record, exclude securities that are received either pursuant to an employee compensation plan in transactions exempt from the registration requirements of Section 5 of the Securities Act or in arrangements that do not involve a sale within the meaning of Section 2(a)(3) of the Securities Act. The latter category is intended to capture the issuance of compensatory grants made by an employer to broad groups of employees pursuant to stock bonus plans under the theory that the awards are not an offer or sale of securities under the Securities Act.

When determining whether it is required to register a class of equity securities, a company can exclude securities only while the securities are held by persons specified in Rule 701(c) who received the securities under the specified circumstances (including their family members who acquire securities through gift or domestic relations order). Once these persons transfer the securities, whether or not for value, the securities would need to be counted as held of record by the transferee for purposes of determining whether the company is subject to the registration requirements of Exchange Act Section 12(g)(1). Therefore, employee compensation plans that permit employees to sell the securities they receive under the plan could still cause a company to exceed the registration thresholds.

Safe Harbor for Determining Holders of Record

As required by the JOBS Act, the SEC is also proposing a non-exclusive safe harbor under proposed Exchange Act Rule 12g5-1(a)(7) to enable companies to determine whether holders of their securities received the securities pursuant to an employee compensation plan in transactions exempt from registration under the Securities Act. As discussed above, these securities can be excluded when calculating the number of holders of record of a class of equity securities for purposes of determining a company's registration obligation. The proposed safe harbor provides that a person will be deemed to have received the securities pursuant to an employee compensation plan if they received them pursuant to a compensatory benefit plan in transactions that met the conditions of Securities Act Rule 701(c). A company would be able to rely on the safe harbor for determining the holders of securities issued in reliance on Securities Act Rule 701, as well as holders of securities issued in transactions otherwise exempted from, or not subject to, the registration requirements of the Securities Act, such as securities issued in reliance on Section 4(a)(2), Regulation D or Regulation S under the Securities Act, in each case that meet the Rule 701(c) conditions.

Under the proposed rule amendments, a foreign private issuer would be able to rely on the safe harbor when making its determination of the number of US resident holders under Exchange Act Rule 12g3-2(a). Under Rule 12g3-2(a), a foreign private issuer that exceeds the asset and total record holder thresholds of Section 12(g) is exempt from registering any class of securities under that section if the class of securities is held by fewer than 300 holders resident in the United States.[5] However, in contrast to the proposed approach to Rule 12g3-2(a), the SEC is proposing to amend Exchange Act Rule 3b-4 that includes the definition of "foreign private issuer" to clarify that securities held by employees must continue to be counted for the purpose of determining the percentage of a foreign company's outstanding securities held by US residents. Therefore, these securities will also need to be taken into account when a foreign company determines whether it qualifies as a foreign private issuer.[6]

Conclusion

As discussed above, the SEC is proposing to change its rules governing registration and reporting thresholds, to provide guidance on the application of the amended thresholds to "accredited investors," to amend the definition of "held of record" and to create a related safe harbor for determining the holders of record for the purposes of registration thresholds. While these amendments appear to be primarily technical and, in most instances, correspond to the rulemaking mandates in the JOBS Act, they may well result in private companies needing to implement new procedures to track the status of their shareholders.

5 Even though the proposal is increasing the record holder thresholds in Rule 12g-1 for companies generally to 2,000 persons, it is not amending Rule 12g3-2(a) to align the 300-US-resident-holder criterion with the new 2,000-record-holder standard.

6 Pursuant to Rule 3b-4(c), a foreign private issuer is any foreign issuer other than a foreign government, except for an issuer that (1) has more than 50% of its outstanding voting securities held of record by US residents and (2) has any of the following: (i) a majority of its officers and directors are citizens or residents of the United States; (ii) more than 50% of its assets are located in the United States; or (iii) its business is principally administered in the United States.

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