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SEC Finalizes Rules Implementing JOBS Act and FAST Act Provisions Concerning Exchange Act Registration Thresholds

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On May 3, 2016, the Securities and Exchange Commission (SEC) adopted final rules regarding the thresholds for registration, termination of registration and suspension of reporting under Section 12(g) of the Securities Exchange Act of 1934, as amended (Exchange Act) mandated by the Jumpstart Our Business Start-ups Act (JOBS Act) and the Fixing America's Surface Transportation Act (FAST Act). In large part, the final rules merely align the SEC's rules with changes effected by the JOBS Act and FAST Act, but it is worth noting the specific rule changes, and accompanying guidance, described below.

I. Amendments to Exchange Act Reporting Thresholds

To implement the increased registration threshold provisions of the JOBS Act and the FAST Act, the SEC has amended Rules 12g-1 through 12g-4 and 12h-3, which govern the procedures relating to registration and termination of registration under Section 12(g) of the Exchange Act. For non-bank issuers, in addition to having in excess of $10 million in total assets, the threshold number of holders of any class of equity securities necessary to trigger Section 12(g) reporting obligations was increased from 500 holders of record to 2,000 holders of record, or 500 holders of record who are not "accredited investors." In the case of a foreign private issuer, in addition to these thresholds, Section 12(g) reporting is not required unless 300 or more of the holders of record are U.S. residents. In the case of a bank, a savings and loan holding company (as defined in section 10 of the Home Owners' Loan Act) or a bank holding company (as defined in Section 2 of the Bank Holding Company Act of 1956), reporting obligations are triggered when the company has total assets exceeding $10 million and over 2,000 holders of record. In addition, a bank, bank holding company or savings and loan holding company may terminate or suspend the registration of a class of securities under the Exchange Act if the securities are held by fewer than 1,200 persons (increased from the 300-person threshold that applies to other issuers). Further, such entities can rely on these rules to cease reporting during a fiscal year, rather than having to wait 90 days or until the end of the reporting year as prescribed under the Exchange Act.

II. Applicable Definition of "Accredited Investor"

The rules further amend Rule 12g-1 to clarify that the definition of "accredited investor" found in Rule 501(a) under the Securities Act of 1933, as amended (Securities Act) applies to determinations for purposes of Section 12(g)(1), with the determination made as of the last day of each fiscal year rather than at the time of a securities issuance (as under Rule 501(a)). This includes the notion found within Rule 501(a) that an accredited investor includes a person that comes within one of the categories of the definition or that the issuer "reasonably believes" comes within any such category. Accordingly, an investor must determine, based on then-current facts and circumstances, whether prior information possessed by the issuer provides a basis for a reasonable belief that a holder continues to be an accredited investor. It is notable that the SEC declined to establish a safe harbor that would allow an issuer to conclusively establish that a security holder is an accredited investor. Instead, issuers are directed to consider "their particular facts and circumstances in establishing a reasonable basis for their determination." Factors that an issuer can take into account include such things as information obtained during a securities issuance, third-party certifications and annual confirmations from investors, although none of these is considered dispositive.

Given that the ability to determine accredited investor status on a timely basis may be critical to companies that are close to the 500-holder threshold, companies should consider what steps might be appropriate to facilitate this determination.

III. Amendments to Definition of "Held of Record" in Exchange Act Rule 12g5-1

The SEC also finalized amendments to the definition of "held of record" in Rule 12g5-1 to provide that, when determining whether registration is required under Section 12(g)(1), an issuer may exclude securities held by persons who received them under an employee compensation plan in transactions exempt from, or not subject to, the registration requirements of Section 5 of the Securities Act and, in certain circumstances, held by persons who received them in exchange for securities received under an employee compensation plan. This is an important change because excluding such securities significantly reduces the risk of a private company inadvertently becoming subject to the reporting requirements of the Exchange Act.

As part of this change, the SEC established a non-exclusive safe harbor for determining holders of record which provides that:

- An issuer may deem a person to have received the securities under an employee compensation plan if the plan and the person who received the securities under the plan met the enumerated conditions of Securities Act Rule 701(c). (Family members who receive equity securities as a result of the employee's (or former employee's) gift, domestic relations order, or death are also considered to be persons who "received [the] securities pursuant to an employee compensation plan" for purposes of Rule 12g5-1).

- An issuer may, solely for the purposes of Section 12(g), deem the securities to have been issued in a transaction exempt from, or not subject to, the registration requirements of Section 5 of the Securities Act if the issuer reasonably believed at the time of the issuance that the securities were issued in a transaction meeting the requirements of Rule 701(c). Consistent with Rule 701(c), securities held of record by former employees would be excluded when determining the securities held of record only if the employees were employed by or providing services to the surviving issuer at the time the exchange securities were offered.

It should be noted that this exception for securities received under an employee compensation plan applies *only* while the shares are held by the person who received them under the plan, so once these persons subsequently transfer the securities to holders not specified in Rule 701(c), the securities must be counted as held of record for purposes of determining registration and reporting requirements of Section 12(g)(1). Plans that permit employees to resell these securities could quickly exceed the "holders of record" thresholds. Therefore, companies should monitor resales by holders that receive shares in connection with an employee compensation plan and should consider implementing procedures designed to limit such resales to ensure that the relevant thresholds are not inadvertently crossed. In this context, either the plan or the underlying award agreement would typically contain provisions designed to limit the number of holders (such as provisions regarding call rights or rights of first refusal by the company). Private companies that have issued securities pursuant to an employee compensation plan should ensure that their record-keeping procedures allow them to track when and to whom a person that received securities under an employee compensation plan transfers such securities.

Foreign private issuers are able to exclude securities received pursuant to an employee compensation plan when making their determination of the number of U.S. resident holders under Rule 12g3-2 (to determine if they reach the 300-U.S. holder reporting threshold), however securities held by employees continue to be counted for purposes of determining the percentage of the issuer's outstanding securities held by U.S. residents when assessing foreign private issuer status under the Securities Act.

IV. Practical Implications

The adoption of these amendments completes the SEC rulemaking mandated under the JOBS Act, which was intended to expand and ease methods of capital raising by private companies and reduce their regulatory burdens. Under the revised rules, private companies may be able to attract larger capital investments from a more diverse range of investors or engage in significant capital raising activities before having to decide whether to register under the Exchange Act or to conduct an initial public offering. In addition, as the higher reporting thresholds allow privately-held companies to delay going public, a more robust secondary market may develop for the equity securities of such companies. Further, the narrower definition of "holders of record" is designed to enable private companies to issue equity-based awards as part of their compensation strategy without the concern of inadvertently triggering an Exchange Act registration requirement.

Finally, the increased threshold for registration and deregistration of a class of equity securities issued by banking entities provides greater flexibility for such companies to engage in additional private capital raising without the concerns of SEC registration and may allow them to deregister even if they have a significant shareholder base.

Companies will need to pay close attention to who holds their securities to ensure that they stay within the prescribed requirements while availing themselves of the greater flexibility provided by the increased registration thresholds and associated rule changes.

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