Client Alert

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SEC Proposes New Exchange Act Regulations in Conformity with JOBS Act

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On December 18, 2014, the Securities and Exchange Commission (SEC) proposed new rules regarding the thresholds for registration, termination of registration and suspension of reporting under Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act")[1], as amended in 2012 by the JOBS Act. The SEC has requested that comments on the proposed rules be received by March 2, 2015.

Registration Requirements

Prior to amendment by the JOBS Act, U.S. issuers were required to register a class of equity securities under the Exchange Act if (i) the securities were "held of record" by 500 or more persons, and (ii) the issuer held more than $10 million of total assets, each measured as of the last day of the issuer's fiscal year.

In an effort to provide issuers with greater opportunities to raise capital without subjecting them to the reporting requirements of registration under the Exchange Act, the JOBS Act revised Section 12(g) of the Exchange Act to increase the threshold at which an issuer is required to register its equity securities.

As a result of the JOBS Act, an issuer that is not a bank or a bank holding company must register a class of equity securities under the Exchange Act if the issuer has total assets in excess of $10 million and the class of equity securities is "held of record" by either (a) 2,000 persons or (b) 500 persons who are not accredited investors.

The JOBS Act also amended the Exchange Act to require a bank or bank holding company to register its equity securities under the Exchange Act if it has total assets in excess of $10 million and a class of equity securities that is "held of record" by 2,000 or more persons (without regard to whether any of such persons are accredited investors).

[1] Full text of the proposed changes may be found at this link.

Thresholds for Termination of Registration; Banks and Bank Holding Companies

The JOBS Act relaxed the termination and suspension of Exchange Act registration obligations for banks and bank holding companies by permitting a bank or bank holding company to terminate its registration or suspend its reporting obligations if it has fewer than 1,200 record holders, an increase from the former threshold of fewer than 300 record holders. The threshold for other issuers to terminate or suspend their Exchange Act registration or reporting requirements for a class of equity securities remains at fewer than 300 record holders.

The SEC proposes to amend Rules 12(g)(1), 12(g)(2), 12(g)(3), 12(g)(4) and 12(h)(3) so that the provisions governing registration and termination of registration under Section 12(g) of the Exchange Act, and suspension of reporting obligations under Section 15(d) of the Exchange Act, conform to the levels prescribed by the JOBS Act.

If adopted, the proposed amendments to the thresholds for banks and bank holding companies would expand the existing provisions of Rule 12(g)(4) and Rule 12(h)(3) to conform to the termination and suspension thresholds provided for in the JOBS Act. This change would allow banks and bank holding companies to rely on the SEC's rules to suspend reporting immediately, and to terminate their registration during the fiscal year, at the new, higher 1,200-holder threshold.

In the proposing release, the SEC stated that, because it believes that the regulatory oversight applicable to savings and loan holding companies is substantially similar to the regulatory oversight for bank holding companies, the SEC should treat savings and loan holding companies consistently with other depositary institutions under the SEC rules. Therefore, the SEC has also proposed to amend Rule 12(g)(1) to establish an exemption for savings and loan holding companies from the registration requirement that mirrors the exemption for banks and bank holding companies established by the JOBS Act.

Determination of "Accredited Investor" Status

For an issuer to determine whether it has more than 500 holders who are not "accredited investors," the proposed rules rely on the definition of "accredited investor" found in Rule 501(a) of Regulation D, under the Securities Act of 1933. The complication is that under Regulation D, an investor's "accredited" status is determined at the time of a Regulation D offering, whereas, under the proposed rules, accreditation would be determined annually on the last day of the issuer's fiscal year.

Obviously, the fact that an investor was accredited at the time of an offering does not mean that the investor will be accredited after a year or more. The SEC's position is that issuers may not necessarily rely on information obtained from an investor upon an initial sale of securities. Under the proposed rules, issuers must decide, "based on facts and circumstances," whether it would be appropriate to rely upon information obtained previously from a particular investor in forming a "reasonable basis" for believing that a particular investor is accredited as of the last day of the issuer's fiscal year.

This has particular importance for private issuers whose securities are held by a large number of accredited investors. Unless the SEC issues additional guidance, it will be unclear what will provide a "reasonable basis" for deciding that investors are accredited as of the end of the issuer's fiscal year. Some issuers may find it necessary to send a questionnaire to shareholders every year to help establish reasonable basis, and may find it difficult to obtain responses from all shareholders without substantial effort.

The SEC is considering what approach would be appropriate for determining accredited investor status under Section 12(g) of the Exchange Act and is specifically soliciting comment on the appropriate structure

and criteria for such an approach. However, it is not too early for private companies that have a large number of shareholders to consider charter amendments that would require that shareholders respond to inquiries regarding their accredited investor status, as shareholders that persistently fail to confirm their accreditation must be counted as unaccredited investors.

Employee Compensation-Related Securities

The JOBS Act also directed the SEC to modify the definition of "held of record" under Exchange Act Section 12(g)(5) to exclude securities held by persons who received the securities in exempt transactions under an "employee compensation plan" and to create a safe harbor for issuers to follow when making that determination.

The SEC has proposed amending Exchange Act Rule 12(g)(5)(1) so that, in determining whether an issuer is required to register a class of equity securities with the SEC, securities "held of record" would not include securities held by persons who received such securities pursuant to an "employee compensation plan" in transactions exempt from the registration requirements of Section 5 of the Securities Act or that did not involve a sale within the meaning of Section 2(a)(3) of the Securities Act.

The definition of "employee compensation plan" would come by way of Rule 701(c), the SEC's exemption for securities issued under employee compensation plans. The safe harbor would exclude from "held of record" calculations any holders of securities received pursuant to "any purchase, savings, option, bonus, stock appreciation, profit sharing, thrift, incentive, deferred compensation, pension or similar plan" in a transaction that met the conditions of Rule 701(c). The safe harbor would apply as long as the conditions of Rule 701(c) are met, even if any conditions set forth in other portions of Rule 701, such as issuer eligibility, volume limitations or disclosure delivery provisions, are not met.

The 701(c) test is not rigorous for determining the existence of a "compensatory benefit plan." In general, under 701(c) the plan or agreement must be in writing, established by the issuer, its parents, subsidiaries or sibling entities under common control, and must be for compensatory rather than capital-raising purposes.

As proposed, the safe harbor would be available not only to employees, but to all plan participants described in Rule 701(c), which includes employees, directors, general partners, officers, and certain consultants and advisors and their family members who acquire such securities from such persons through gifts or domestic relations orders (but not, for purposes of the proposed rules, their assignees, who would have to be counted as record holders). The rule also exclude from the "held of record" count *former* employees or other eligible recipients, if such persons were employed by or providing services to the issuer at the time the securities were offered.

The proposed safe harbor is nonexclusive, so that failure to satisfy the conditions of Rule 701(c) would not preclude reliance on Section 12(g)(5) of the Exchange Act (which excludes from the definition of "held of record" securities "held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of section 5 of the Securities Act of 1933") or other provisions of proposed Rule 12(g)(5)(1)(a)(7).

The proposed rules would also permit the issuer to exclude securities held by persons (1) who are eligible to receive securities from the issuer pursuant to Securities Act Rule 701(c), and (2) who received the securities in an exempt transaction *in exchange for* compensatory securities that had been excludable from the determination of securities held of record. This exclusion for securities obtained in exchange

transactions is intended to facilitate an issuer's ability to engage in restructurings, business combinations and similar transactions that are exempt from registration under the Securities Act.

Foreign private issuers that are required to determine their US resident holders for the purpose of Rule 12(g)(3)(2)(a) (which exempts foreign private issuers from registering any class of securities if such class is held by fewer than 300 holders resident in the United States) would be able to rely on the proposed safe harbor for securities issued pursuant to employee compensation plans.

Determination of Holders under Employee Compensation Plans

Under the proposed rules, issuers with substantial holders of employee compensation securities will need to monitor ownership to keep track of when transfers of the securities are made to persons who must be counted as holders of record who would count against the 2,000-holder limit. There is likely to be a great deal of confusion in the administration of these rules, and a need to establish clear guidelines for corporate administrators.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the author of this alert.

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