SEC Proposes New Exchange Act Registration Thresholds and Changes to Certain "Held of Record" Definitions

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Background

On December 18, 2014, the Securities and Exchange Commission proposed new rules regarding the thresholds at which issuers may become reporting companies under Section 12(g) of the Securities Exchange Act of 1934, as amended in 2012 by the JOBS Act (see the full text of the release here). The SEC has requested that comments on the proposed rules be received by March 2, 2015.

This Alert describes the new registration thresholds in the proposed rules and highlights two key areas to which issuers should pay close attention going forward:

- an issuer's obligation to verify the "accredited" status of its stockholders at the end of each fiscal year, and
- the implementation of a safe harbor permitting issuers to exclude from "held of record" calculations stockholders who receive securities under an "employee compensation plan."

Registration Thresholds under the JOBS Act

Prior to amendment by the JOBS Act, federal securities laws required U.S. issuers to register a class of equity securities 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.

Consistent with its goal to provide issuers with greater opportunities to raise capital without subjecting them to the burdensome reporting requirements of registration under the Exchange Act, the JOBS Act increased the "held of record" threshold to either (i) 2,000 stockholders or (ii) 500 persons who are not "accredited" investors. In addition, with respect to issuers that are banks, bank holding companies or savings associations, the JOBS Act increased the "held of record" threshold to 2,000 or more persons, regardless of their "accredited" status. The SEC also proposed various other rules specifically applicable to banks and bank holding companies (treating a savings and loan holding company as a bank holding company for these purposes), which are beyond the scope of this Alert.

Determination of "Accredited Investor" Status

Rather than creating a new definition of "accredited investor" for purposes of Section 12(g) of the Exchange Act, the proposed rules rely on the classic definition of "accredited investor" found in Rule 501(a) of the Securities Act of 1933. However, while investor status is established at the time of the related exempt transaction, an investor's "accredited" status for purposes of determining an issuer's registration obligations would be determined annually on the last day of the issuer's fiscal year.

Under Regulation D, which is commonly used by issuers to raise private capital, status as an accredited investor is established either by self-certification by the investor (Rule 506(b)) or by verified certification (Rule 506(c)), which can be achieved using various safe harbors. However, an investor's accredited status at the time of an investment clearly may not continue in effect at the end of each fiscal year of the issuer. With respect to an issuer's use of information previously obtained from investors verifying their accredited status, the SEC's position is that issuers may not necessarily rely on information obtained from an investor upon an initial sale of securities. Rather, issuers must decide, "based on facts and circumstances," whether it would be appropriate to rely exclusively 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.

For a private issuer whose securities are held by a large number of accredited investors, this will pose significant challenges, especially if the SEC's final rules provide no additional guidance or specific examples of what would constitute a "reasonable basis" for deciding that a particular investor is accredited as of the end of the issuer's fiscal year. Issuers may want to resort to the use of a questionnaire sent to stockholders each year to help establish reasonable basis.

Employee Compensation Related Securities

As noted, issuers would also be able to exclude from "held of record" calculations stockholders who receive securities under an "employee compensation plan." In contrast to the SEC's unhelpful treatment of an issuer's annual obligation to determine the accredited status of its stockholders, the proposed rules provide greater clarity with respect to the exclusion of certain holders of employment-related securities from the "held of record" calculations under Section 12. The SEC concluded that securities "held of record" do not include securities held by persons who received such securities pursuant to an "employee compensation plan" in exempt or "no sale" transactions under the Securities Act.

Rather than defining "employee compensation plan" anew, the SEC proposed the adoption of a safe harbor that relies upon the broadly-defined "compensatory benefit plan" found in Rule 701(c) of the Securities Act. This 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). For example, in order to qualify as a "compensatory benefit plan" under Rule 701(c), a plan must be written and delivered to employees, and the amount of securities sold under the plan must be limited.

As proposed, the safe harbor would be available to the full class of plan participants described in Rule 701(c), which includes employees, directors, general partners, officers, and certain consultants and advisors, among others. Once such holders transfer the securities, however, the securities would need to be counted as held of record for determining whether the registration thresholds have been met. (Certain transfers, such as to family members, would not change the status of the securities for this purpose.)

Administrative Burdens on Private Companies

As with the annual determination of accredited status, the favorable treatment of holders of employee compensation securities will require issuers to be vigilant about tracking transfers to persons who will be treated as record holders and count against the 2,000 holder limit. These administrative burdens may be difficult for some private companies, who either will not have the resources to make these investigations effectively, or will ignore the rules until it becomes more difficult to make the requisite determinations.

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