Securities and Exchange Commission Amends Rules to Implement Registration Requirements of JOBS Act and FAST Act

On May 3, 2016, the US Securities and Exchange Commission (SEC) adopted amendments to the registration, termination of registration and suspension of reporting requirements of rules under the Securities Exchange Act of 1934 (Exchange Act) in order to implement provisions of the Jumpstart Our Business Startups Act (JOBS Act) and the Fixing America's Surface Transportation Act (FAST Act).[1] These amendments will become effective 30 days after publication in the Federal Register.

Background

In 2012, the JOBS Act amended the thresholds for registration, termination and suspension of reporting under the Exchange Act. As a result of the JOBS Act, an issuer that is not a bank or a bank holding company must register equity securities under the Exchange Act if:

- It has total assets in excess of $10 million and
- The class of equity securities is "held of record" by either
  - 2,000 persons or
  - 500 persons who are not accredited investors.

The JOBS Act requires 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
- Securities are "held of record" by 2,000 or more person (without regard to whether any persons are accredited investors).

The JOBS Act relaxed the termination and suspension of Exchange Act registration obligations for banks and bank holding companies by increasing the record holder threshold from less than 300 to less than 1,200 persons before a bank or bank holding company can terminate its registration or suspend its reporting obligations. The threshold for other issuers to terminate or suspend their Exchange Act registration or reporting requirements for a class of equity securities remains at less than 300 record holders.

The JOBS Act also directed the SEC to modify the definition of "held of record" pursuant to Exchange Act Section 12(g)(5) so that it would 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 FAST Act adjusted Exchange Act thresholds for registration, termination of registration and suspension of reporting by savings and loan holding companies (which were not covered by the JOBS Act), so that they would be the same as the corresponding thresholds for banks and bank holding companies.

As a result of the recently adopted amendments, the SEC's Exchange Act registration regulations

now reflect the JOBS Act and FAST Act changes to such requirements, as well as a non-exclusive safe harbor for determining holders of record. The SEC has now completed all rulemaking mandated by the JOBS Act.

Discussion

Threshold Requirements. The SEC amended Rules 12g-1, 12g-2, 12g-3, 12g-4 and 12h-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 reflect the threshold levels established by the JOBS Act. The amended rules apply to savings and loan holding companies in the same manner as banks and bank holding companies.

The amendments to the thresholds for banks and bank holding companies expand the existing provisions of Rule 12g-4 and Rule 12h-3 to encompass the termination and suspension thresholds provided for in the JOBS Act and the FAST Act. This allows banks, bank holding companies, and savings and loan holding companies to rely on the SEC's rules to suspend reporting immediately, to avoid being deemed registered upon termination of certain exemptions or as a successor issuer and to terminate their registration during the fiscal year (i.e., upon filing Form 15) once the holders of record fall below the 1,200 threshold.

Accredited Investor Definition. The JOBS Act increased the Exchange Act thresholds for registration by an issuer other than a bank or a bank holding company to total assets exceeding $10 million and a class of non-exempted equity securities held of record by either 500 persons who are not accredited investors or 2,000 persons. In order to rely on the new, higher threshold, issuers must be able to determine which of their record holders qualify as accredited investors. The amended rules use the definition of "accredited investor" set forth in Rule 501(a) under the Securities Act of 1933 (Securities Act), which is part of the Regulation D limited offering exemption, to determine if investors are accredited investors for purposes of the registration provisions of Exchange Act Section 12(g)(1). Under amended Rule 12g-1, the accredited investor determination would be made as of the last day of the fiscal year (as opposed to at the time of sale of the securities). According to the adopting release, a company will need to determine whether prior information provides a basis for a reasonable belief for a year-end accredited investor determination based on the particular facts and circumstances surrounding that determination.

Held of Record Definition. Section 12(g)(5) of the Exchange Act, as amended by the JOBS Act, provides that the definition of "held of record" does not include securities held by persons who received them pursuant to an employee compensation plan in transactions exempt from registration under Section 5 of the Securities Act. To implement this provision, the SEC has amended Rule 12g5-1 so that, in determining whether it is required to register a class of equity securities with the SEC, the issuer may exclude securities that are held by persons who received the securities pursuant to an "employee compensation plan" (a phrase that is not defined in the rule or in the corresponding statutory provision) in transactions exempt from, or not subject to, the registration requirements of Section 5 of the Securities Act.

Amended Rule 12g5-1 also permits an issuer to exclude securities from the "held of record" determination if the securities are held by persons who received them from the issuer, a predecessor of the issuer or an acquired company in substitution or exchange for excludable securities as described in the preceding paragraph. In order for securities to be excluded:

- The substitution or exchange transaction must have been exempt from, or not subject to, the registration requirements of Section 5 of the Securities Act, and

- The persons holding such securities, at the time the excludable securities were originally issued to them, must have been eligible to receive securities pursuant to Securities Act Rule 701(c), which is described in more detail below.

This exclusion for securities obtained upon a qualifying substitution or exchange is intended to facilitate the issuer's ability to engage in restructurings, business combinations and similar transactions that are exempt from registration under the Securities Act, with language intended to accommodate the various ways in which a former employee may have received securities in such transactions.

Safe Harbor for Determining Holders of Record. The SEC has adopted Rule 12g5-1(a)(8)(ii) as a non-exclusive safe harbor for determining holders of record. The safe harbor allows an issuer to deem a person to have received securities pursuant to an employee compensation plan if the plan and the person who received the securities pursuant to the plan met the plan and participant conditions of Securities Act Rule 701(c). This part of 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. As a result, the safe harbor is available for holders of securities received in other employee compensation plan transactions exempted from, or not subject to, Securities Act registration requirements. For example, the safe harbor could be available for securities issued in reliance on Securities Act Section 4(a)(2), or Regulation A, Regulation D or Regulation S under the Securities Act, as long as the relevant transactions meet the conditions of Rule 701(c). Because the safe harbor is non-exclusive, failure to satisfy all of the conditions of Rule 701(c) would not preclude reliance on Section 12(g)(5) of the Exchange Act or other provisions of Rule 12g5-1(a)(8).

This aspect of the safe harbor is only available for securities issued pursuant to an employee compensation plan to persons specified in Rule 701(c). This includes employees, directors, officers, general partners, and certain trustees, consultants and advisors of the issuer, a parent or majority-owned subsidiary, as well as persons who formerly served in such roles so long as they were employed by or provided services to the issuer at the time the securities were offered. The safe harbor is also available for permitted family member transferees for securities acquired by gift or domestic relations order from plan participants or in connection with options transferred to them by plan participants through gifts or domestic relations orders. If a person specified in Rule 701(c) subsequently transfers the securities to a person not specified by that rule, whether or not for value, the securities would need to be counted as being held of record by the transferee for purposes of determining whether the issuer is subject to the Exchange Act's registration and reporting requirements.

The safe harbor also contains a provision for determining whether securities were issued in a transaction exempt from, or not subject to, the registration requirements of Section 5 of the Securities Act. Specifically, Rule 12g5-1(a)(8)(ii)(B) allows the issuer, solely for the purposes of Section 12(g) of the Exchange Act, to deem 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 had a reasonable belief at the time of issuance that the securities were issued in such a transaction. As explained in the adopting release, this section of the safe harbor relieves issuers from the burden of establishing on an annual basis that earlier issuances of securities satisfied an appropriate exemption as long as the issuer had a reasonable belief that it had complied with the appropriate registration requirements or the conditions of an applicable exemption at the time the securities were issued.

Securities Act Rule 701(c). Existing Securities Act Rule 701(c) plays a role in the amendment to the definition of "held of record" and to the safe harbor for compensatory securities. Briefly, Rule 701(c) exempts offers and sales of securities under a compensatory benefit plan to specified participants. Rule 701(c) requires that the compensatory benefit plan be:

- Written;
- 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, officers, general partners and trustees (where the issuer is a business trust);
- Applicable only to specified family members; and
- Compliant with special requirements for consultants and advisors.

Foreign private issuers. Foreign private issuers may rely on the definition of "held of record" and the related safe harbor for securities issued pursuant to employee compensation plans set forth in Rule 12g5-1(a)(8), which is discussed above, when making their determination of the number of US resident holders for the purpose of Rule 12g3-2(a). Rule 12g3-2(a) 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.

Practical Considerations

To a large degree, the amendments discussed in this Legal Update adjust SEC rules to reflect existing JOBS Act and FAST Act changes to the Exchange Act registration requirements.

As a result of the amended rules, companies may need to adopt new due diligence procedures if they are close to triggering registration, deregistration or suspension thresholds because of the number of their shareholders who are not accredited investors. These companies should consider putting such procedures in place as early as possible to provide better tracking and planning. Private companies not currently subject to Exchange Act reporting requirements may want to consider adopting provisions in their governing documents to require investors to respond to inquiries as to accredited investor status, possibly providing for the mandatory buy-out of persons who do not demonstrate that they qualify for such status, or who are not accredited investors, if the company determines it is necessary or advisable to avoid triggering the Exchange Act registration requirements.

Companies should consider whether employee compensation plans that permit transfers of securities received under such plans could cause them to exceed thresholds and thereby require registration under the Exchange Act. If there are issues, companies should consider what, if any, revisions they want to make to such plans. In any event, a company in this situation should implement due diligence procedures to track ownership of securities issued pursuant to employee compensation plans and consider whether buyback or right-of-first-refusal provisions should be added to the plan documents if the company determines it is necessary or advisable to avoid triggering the Exchange Act registration requirements.

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Endnote

[1] See Release No. 33-10075; 34-77757, available https://www.sec.gov/rules/final/2016/33-10075.pdf