CARLTON FIELDS

JOBS Act Eases Requirements for Triggering SEC's Exchange Act Registration

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In an effort to enhance access to capital, Jumpstart Our Business Startups Act ("JOBS Act") was enacted on April 5, 2012. The JOBS Act includes provisions affecting both registered and exempt offerings. For privately-held companies that seek additional capital but are not ready for, or interested in, becoming public companies subject to the reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act"), the JOBS Act includes provisions that expand the ability of companies to raise capital through private transactions that are not subject to the registration under the Securities Act of 1933 (the "Securities Act") while also increasing the thresholds that require companies to register with the Securities and Exchange Commission ("SEC") under the Exchange Act. For a more detailed description of the expanded private capital raising activities created under the JOBS Act, please see our firm's bulletin "*The JOBS Act Enhances Private Capital Raising Activities*." Collectively, these new provisions are designed to increase the opportunities for companies to raise capital from private offerings and remain private longer, thereby avoiding the costs and the resource expenditures associated with being a public company subject to SEC reporting requirements. **Exchange Act Registration Requirements** The primary purpose of Exchange Act registration is to establish the basis for providing a constant flow of information about a company to its shareholders and the trading markets. A company becomes subject to the reporting requirements of the Exchange Act (a "Reporting Company") either as a result of having conducted a registered public offering of its securities under the Securities Act or through a voluntary or involuntary registration under Section 12 of the Exchange Act. A voluntary registration often is undertaken because the company seeks a listing of its securities on a national securities exchange that requires such registration as a listing condition, it is contractually obligated to do so, or it has otherwise determined that it would be beneficial for it to be a Reporting Company (e.g., improve the market for its securities, subject the company to the tender offer and proxy rules as a protective measure, etc.). On the other hand, a company that has not conducted a registered offering and does not have its securities listed on a national securities exchange will nonetheless be required to register its equity securities under the Exchange Act if it exceeds certain asset and

shareholder base thresholds established under the Exchange Act. Prior to the enactment of the JOBS Act, Section 12(g) of the Exchange Act, as modified by rules promulgated thereunder, required companies with more than $10 million of assets and a class of equity securities held of record by 500 or more holders at the end of its fiscal year to register that class of equity securities with the SEC. The JOBS Act has amended Section 12(g) of the Exchange Act to increase the holders of record threshold that triggers Exchange Act registration and the corresponding periodic reporting obligations. **New Thresholds for Exchange Act Registration** Under the amended Section 12(g) of the Exchange Act, companies are now required to register their equity securities under the Exchange Act only when they have more than $10 million in assets and a class of equity securities held of record by either:

- 2,000 persons, or

- 500 persons or more who are not "accredited investors" as defined under applicable SEC rules. Generally, accredited investors currently include persons or entities that meet certain income or net worth requirements.

The increased thresholds were effective immediately upon the enactment of the JOBS Act. **Determining Shareholders of Record** The key factor in determining whether a privately-held company is required to register under Exchange Act is the calculation of the number of its holders of record. A holder of record generally is the person or entity identified in the records maintained by a company (or its transfer agent) as the registered holder of the company's securities. The record holder may not necessarily be the beneficial owner of the securities (e.g., shares held in street name by brokers on behalf of their clients). Privately-held companies may issue their equity securities over a prolonged period of time in a series of private offerings and to employees, consultants and agents in connection with compensation arrangements. Those shares are often held directly by the recipient and are not held by a nominee or in street name. As a result, privately-held companies engaged in such offerings and issuances may experience a rapid growth in the number of record holders of their equity securities, especially as a result of those issued in connection with compensation arrangements, which potentially could require a company to register under the Exchange Act before being adequately prepared to take on the resultant obligations. Accordingly, privately-held companies wishing to raise capital by admitting new investors or issuing equity under compensation arrangements must continually monitor their outstanding holdings in order to avoid inadvertently triggering the Section 12(g) registration requirements. However, in addition to increasing the holder of record thresholds, the JOBS Act also includes provisions that specifically exempt certain securities from the calculation of holders of record for purposes of Section 12(g) of the Exchange Act. For these purposes, the JOBS Act provides that the definition of "held of record" will not include securities held by employees pursuant to certain employee compensation plans or issued pursuant to the crowdfunding exemption from Securities Act registration also established under the JOBS Act. **Employee Compensation Plans** The JOBS Act makes it easier for privately-

held companies to reward or otherwise compensate their employees with options or other equity awards without increasing their shareholder base for purposes of Section 12(g) of the Exchange Act. When calculating record holders, the JOBS Act provides that the "held of record" will not include securities:

- held by persons who *received* securities pursuant to an employee compensation plan (e.g., a stock option plan)

- in *transactions* exempt from the registration under of Section 5 of the Securities Act (e.g., Rule 701, Regulation D, etc.).

This exclusion from the calculation of holders of record under Section 12(g) of the Exchange Act would appear to apply to both current and former employees of the company, but not to a transferee of the shares from any current or former employee of the company. This exclusion may prove to be very helpful for small, privately-held companies that compensate or otherwise incentivize key employees with shares of its stock. The JOBS Act requires the SEC to revise its rules to implement this amendment to the definition of "held of record" and to adopt safe harbor provisions for companies to follow when determining whether a shareholder who received shares pursuant to an employee compensation plan can be excluded from the holders of record calculation. No time frame has been established for such rulemaking. **Crowdfunding Transactions** The JOBS Act also authorizes a new source of capital raising activity referred to as "crowdfunding" which, under certain circumstances, permits privately-held companies that are not subject to the reporting requirements of the Exchange Act to raise a limited amount of equity-based financing from an unlimited number of investors. Crowdfunding offerings made pursuant to the provisions of the JOBS Act are exempt from registration under the Securities Act. For a more detailed description of the crowdfunding exemption, please see our firm's bulletin "*The Crowdfunding Act and Its Implications for Smaller Companies*." By using the crowdfunding exemption, companies will have access to a wider pool of smaller investors from whom it may seek capital investment. As a result, companies that engage in crowdfunding offerings could potentially experience a substantial increase in the number of record holders while raising relatively small amounts of capital. However, the JOBS Act also specifically provides that the SEC shall adopt rules that exempt from the calculation of holders of record under Section 12(g) of the Exchange Act, securities acquired in a "crowdfunding" transaction. This rulemaking, as well as the implementing rules for crowdfunding in general, are to be completed within 270 days of the enactment of the JOBS Act (December 31, 2012). **Accredited Investors** In addition to the calculation of the number of holders of record, it also is necessary under the JOBS Act to determine how many of the holders of record are accredited investors. Accredited investors are persons or entities that, due to their level of investment sophistication, net worth, income or other factors, are deemed to be able to fend for themselves in considering an investment opportunity and, as a result, are afforded less protections in connection with private offerings than those who are not accredited. In determining whether a company is required to register a class of

its equity securities under the Exchange Act, the JOBS Act provides that a company will not have to register until it has 2,000 holders of record so long as it has less than 500 persons who are non-accredited investors (e.g., up to 499 non-accredited holders). Although the SEC has defined what constitutes an accredited investor under Regulation D, it has not provided any guidance for companies to use in confirming a shareholder's status as an accredited investor for these purposes. The SEC has suggested that companies should know their shareholders and whether they satisfy the eligibility requirements. **Deregistering Under the Exchange Act** While the threshold requirements for registering under the Exchange Act have been raised, no change has been made to the eligibility requirements for deregistration of a non-bank company's class of securities under the Exchange Act. Generally, under Section 12(g) of the Exchange Act, a non-bank company is eligible to deregister its securities from registration if its securities are held by less than 300 holders of record. As a result, Reporting Companies that might not have been required to register their securities with the SEC under the revised thresholds must remain registered until they become eligible for deregistration under applicable SEC rules. **Banks and Bank Holding Companies** The JOBS Act provided special provisions relating to Exchange Act registration and deregistration of a class of equity securities issued by banks and bank holding companies. These special provisions also provide greater flexibility for banks and bank holding companies to engage in additional private capital raising without the concerns of SEC registration. More specifically, the JOBS Act provides that a bank or bank holding company:

- is not required to register a class of its equity securities under the Exchange Act until it has more than $10 million in assets and a class of equity securities held of record by 2,000 or more persons; provided, however, that exempted securities are not required to be registered under the Exchange Act.

- with less than 1,200 (increased from 300) holders of record may elect to deregister under Section 12(g) of the Exchange Act.

- with less than 1,200 holders of record may elect to suspend its periodic reporting requirements (e.g., Forms 10-K, 10-Q, 8-K, etc.) under Section 15(d) of the 1934 Act

The threshold applicable to banks and bank holding companies does not have a non-accredited investor limitation that attaches to the 2,000 holder of record threshold. Further, shares issued under Section 3(a)(2) of the Securities Act (i.e., shares issued by a bank) are exempt securities and are not a class of securities subject to Exchange Act registration. **Potential Implications** The increased thresholds for requiring registration under the Exchange Act and the exclusions for certain issuances from the calculation of the number of holders of record for such purposes have the potential to significantly impact private equity financings and compensation practices of privately-

held companies. The potential impact of these changes include, among other things:

- a greater ability to control the timing of the going public determination by growing privately-held companies engaged in successive capital raising activities to sustain their growth.

- when combined with enhanced access to private capital afforded under the JOBS Act through the elimination of the general solicitation and general advertising ban on Rule 506 offerings to accredited investors and to QIBs in Rule 144A transactions, privately-held companies should be able to attract larger sums of capital investment from a more diverse shareholder base.

- privately-held companies will have more flexibility to develop a larger shareholder base, in terms of both size and breadth, before having to make a decision as to whether to register under the Exchange Act or to conduct an initial public offering ("IPO").

- privately-held companies will have more freedom to pursue aggressive compensation strategies that involve issuance of equity based awards without the concern that it may result in an inadvertent Exchange Act registration requirement. However, it may need to take steps to restrict the transfer of such compensation based equity securities so that the sale or transfer of such securities will not increase the number of record holders beyond thresholds for registration created under the JOBS Act.

- steps may need to be taken to determine the accredited investor status of the company's equity holders. The practical implication is that equities are less likely to be sold to non-accredited investors in private capital transactions and/or companies may place specific restrictions on any subsequent transfer of the securities prior to an IPO or Exchange Act registration (e.g., only to accredited investors, subject to company's right of first refusal, etc.). It also should be noted that the SEC has the authority to change the definition of an accredited investor.

- companies engaging in crowdfunding offerings may need to establish a mechanism to track such securities prior to any subsequent IPO or Exchange Act registration (i.e., special legends). The crowdfunding exemption from the calculation of holders of record applies to the securities sold in such transactions, not the purchasers or holders of such securities.

- a more robust secondary market may develop for the equity securities of privately-held companies. This may occur as the result of the ability of a privately-held company to further delay going public under the new holder of record thresholds. It also may be further enhanced by the exemption from broker-dealer registration for providing matching services in connection with Rule 506 offerings. Additional interest in a privately-held company's securities could be generated from such solicitation activities.

- small community banks should be able to more easily raise capital, both privately and in public offerings exempt under Section 3(a)(2) of the Securities Act (i.e., shares issued by a bank), without being required to register under the Exchange Act. In addition, banks and bank holding companies may deregister even at a time when it has a significant shareholder base.

The SEC is required to implement certain rules to provide guidance with respect to the registration and deregistration requirements addressed by the JOBS Act. Such rules have not yet been proposed or adopted, but are expected in the coming months. These rules are expected to address, among other matters, issues relating to the calculation of shareholders of record, determining accredited investor status, and crowdfunding requirements. Therefore, companies should be aware of the upcoming rules and how such rules will impact their capital raising activities.

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