Pre-IPO Companies Can Stay Private Longer

SEC Wraps Up JOBS Act Rulemaking

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On May 3, the SEC approved rule **amendments** that will make it easier for many private companies to remain private, and easier for some public financial companies to terminate their SEC reporting obligations. With the adoption of these amendments, the SEC has completed the rulemaking mandated by Congress under the JOBS Act of 2012.

The amendments:

- Increase numerical thresholds for triggering SEC reporting by pre-IPO companies, based on the extent to which the company's investor base includes "accredited investors" and employee shareholders – providing some companies with the flexibility to stay private longer and develop a larger shareholder base before conducting an IPO;
- Allow companies, when counting their shareholders to see if they are required to register with the SEC, to exclude securities held by persons who received them under equity compensation plans in transactions not subject to SEC registration; and
- Make it easier for some banks, bank holding companies and savings and loan holding companies to exit the SEC reporting regime, based on the size of their shareholder base.

The amendments will become effective on June 9, 2016.

Higher Registration Thresholds

The JOBS Act amended the Securities Exchange Act of 1934 to raise the threshold at which companies become subject to public-company reporting obligations, including ongoing obligations to file Form 10-Ks, 10-Qs and 8-Ks, and to solicit proxies. The JOBS Act also amended the Exchange Act to establish a separate registration threshold for banks and bank holding companies, and in 2015 Congress extended this threshold to savings and loan holding companies. While these statutory amendments were effective immediately upon enactment, they did not amend the SEC's related rules governing the mechanics of registration; these rules have now been amended.

As a result of these changes:

- A company that is not a bank, bank holding company or savings and loan holding company is required to register a class of equity securities under the Exchange Act if, on the last day of its fiscal year, its total assets exceed $10 million and the equity securities are "held of record" by either 2,000 persons, or 500 persons who are not "accredited investors."
- A bank, bank holding company or savings and loan holding company is required to register a class of equity securities under the Exchange Act if, on the last day of its fiscal year, its total assets exceed $10 million and the equity securities are "held of record" by 2,000 or more persons (without regard to accredited investor status).

Prior to these changes, the threshold for all companies was 500 record holders, without regard to accredited investor status.

Accredited Investor Determination

For purposes of determining which record holders are accredited investors, the SEC will apply the well-established definition in Regulation D. This definition includes persons who fall within, or who the company reasonably believes fall within, any one or more of eight categories, such as corporations or partnerships with assets exceeding $5 million, and natural persons whose net worth exceeds $1 million (excluding the value of their primary residence) or who earn $200,000 or more annually. The accredited investor determination must be made as of the last day of the company's fiscal year, although the SEC's adopting release suggests that it may be reasonable for companies to rely on information from the shareholder that is not provided exactly as of that date.

The SEC did not provide much guidance on methods a company should use to establish a reasonable belief about its shareholders' accredited-investor status, and instead told companies to consider their particular facts and circumstances.

Securities Issued Under Employee Compensation Plans

The JOBS Act amended the Exchange Act definition of "held of record" for purposes of determining when a pre-IPO company becomes subject to public-company reporting obligations, in order to exclude securities held by persons who received them under an "employee compensation plan" in transactions exempt from Securities Act registration. The term "employee compensation plan" was not defined in the JOBS Act. The special definition applies solely for purposes of determining when a company is required to enter the public-company reporting system, and does not apply to the test for exiting the system.

Rather than create a new definition for the term "employee compensation plan," the SEC established a non-exclusive safe harbor that relies on the current definition of "compensatory benefit plan" in Securities Act Rule 701(c). Rule 701(c) provides a Securities Act exemption for equity compensation grants to enumerated plan participants and their family members who received such securities via gifts or domestic-relations orders. However, because the safe harbor is limited to holders permitted by Rule 701(c), subsequent transferees of these securities would generally need to be included in the company's "held of record" calculation.

The amended definition of "held of record" also includes provisions to facilitate restructurings, business combinations and similar transactions so that if the securities being surrendered would not have counted as "held of record," the securities issued in exchange also would not count.

Foreign Private Issuers

Foreign private issuers are permitted to rely on the safe harbor when determining whether they have fewer than 300 U.S. resident holders, which is the threshold below which they are exempt from SEC registration. However, the SEC has clarified that securities received by employees under employee compensation plans must continue to be counted when determining the percentage of the company's outstanding securities held by U.S. residents for purposes of determining the company's foreign private issuer status.

Banks, Bank Holding Companies and Savings and Loan Holding Companies

The JOBS Act relaxed the threshold at which public banks and bank holding companies are able to exit their public-company reporting obligations, and in 2015 Congress extended the favor to public savings and loan holding companies. As a result, these financial companies may terminate their public-company reporting obligations if their equity securities are "held of record" by fewer than 1,200 persons. (For other public companies, the exit threshold generally remains unchanged at 300 persons.)

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