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JOBS Act Becomes Law: Reduced Compensation Disclosure for Many IPO Companies and Exchange Act Relief for Private Companies with Significant Equity Compensation

Today President Obama signed the Jumpstart Our Business Startups Act (the "**JOBS Act**"), which was passed by the House of Representatives on March 27, 2012 in the same form passed by the Senate on March 22, 2012. Our March 26, 2012 client memorandum addressed the general capital markets implications of the JOBS Act. This memorandum focuses on those provisions of the JOBS Act that impact compensation, specifically:

- reduced executive compensation disclosure obligations for "emerging growth companies" ("**EGCs**,"[1] or companies with less than $1 billion in total annual gross revenues in the most recently completed fiscal year) that completed an IPO after December 8, 2011 or would like to IPO; and
- increased flexibility for issuance of equity compensation by private companies, without triggering public company reporting requirements.

EGCs' Reduced Compensation Obligations

Item 402 Executive Compensation Disclosure

U.S. public companies (including those that recently completed an IPO) have been subject to a rigorous executive compensation disclosure regime under Item 402 of Regulation S-K, which has expanded over the last several years to include a detailed Compensation Discussion and Analysis (or CD&A), which is the compensation analog to a Management Discussion and Analysis (or MD&A), and multiple tables reporting compensation of the CEO, CFO and at least three other executive officers. Under the JOBS Act, EGCs will be able to meet the Item 402 disclosure requirements by providing the shorter disclosure required of a "smaller reporting company." This means EGCs will not be required to present a CD&A and will be required to provide in their registration statement on Form S-1 and annual proxy statement (or Form 10-K) only:

- compensation of three (rather than five) executive officers, consisting of the CEO and two other most highly compensated executive officers (*i.e.*, not automatically the CFO);
- the Summary Compensation Table and related narrative disclosure, reporting full compensation for up to the last two (rather than three) completed fiscal years;
- the Outstanding Equity Awards at Fiscal Year-End table;
- the Director Compensation table; and
- additional narrative disclosure (*e.g.*, material terms of retirement plans, termination payments and change in control arrangements).

[1] Our March 9, 2012 client memorandum provides more detail as to how an IPOing company qualifies as an EGC. The maximum period of time that a company can qualify as an EGC is five years after the IPO, although it may cease to be an EGC before then (*e.g.*, when the company has issued more than $1 billion in non-convertible debt during the previous three-year period or when it becomes a "large accelerated filer").

Compensation Requirements under Dodd-Frank

EGCs will be exempt from the following compensation-related requirements under Dodd-Frank, of which the first currently applies to most public companies and the latter two are awaiting rulemaking by the SEC:

Shareholder Votes on Compensation. EGCs are exempt from the requirements to conduct shareholder advisory votes on say-on-pay, the frequency of say-on-pay and say-on-golden parachutes. Say-on-pay is an advisory vote whereby shareholders vote on whether to approve the compensation of named executive officers every one to three years. The frequency vote is an advisory vote whereby shareholders vote on whether the say-on-pay vote should be held every one, two or three years. The say-on-golden parachutes vote arises in the event of an M&A transaction and requires an advisory vote of the shareholders on payments made to any named executive officer in connection with such transaction.

Generally, a former EGC must hold a say-on-pay vote no later than one year after it ceases to be an EGC (for example, if an EGC IPOs in 2012, but in 2015 ceases to be an EGC because it becomes a large accelerated filer due to its public equity float, then it must hold a say-on-pay vote in 2016). However, if a company was an EGC for less than two years after the company's IPO, it has up to three years after the IPO to hold the vote.[2]

Pay for Performance. Under Dodd-Frank, public companies will be required to disclose the relationship between the company's executive compensation actually paid and its financial performance. This requirement has been on hold pending SEC rulemaking. When it becomes effective, EGCs will be exempt.

Internal Pay Equity. Dodd-Frank mandates that public companies will be required to disclose: (i) the median annual total compensation of all employees other than the CEO, (ii) the annual total compensation of the CEO and (iii) the ratio of the median employee annual compensation to that of the CEO. This requirement has also been on hold pending SEC rulemaking. When and if it becomes effective, EGCs will be exempt.

Exchange Act Relief and Equity Compensation of Private Companies

The JOBS Act extends existing relief from the registration and reporting requirements under the Securities Exchange Act of 1934 (the "**Exchange Act**") to private companies who rely heavily on equity-based compensation to incentivize employees. Historically, under Section 12(g) of the Exchange Act, an issuer with 500 or more holders of record of any class of equity security and total assets in excess of $10 million at the end of its most recently ended fiscal year was required to register that class of equity security, unless there was an available exemption. Registration under Section 12(g) subjects the issuer to the full reporting requirements applicable to U.S. public companies under the Exchange Act (*e.g.*, annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K).

As described in our March 23, 2012 client newsflash, the JOBS Act increases the shareholder threshold that triggers public company reporting for private companies and provides that an issuer is not required to register under Section 12(g) until it has a class of equity security held of record by either 2,000 persons or 500 persons who are not accredited investors.[3] Notably, in determining the number of holders which could trigger Exchange Act reporting obligations, the JOBS Act excludes persons who received their

[2] The JOBS Act is silent as to when the frequency of say-on-pay vote is required to take place after a company ceases to be an EGC, but presumably companies will hold a frequency vote when they hold their first say-on-pay vote as a non-EGC.

[3] For banks and bank holding companies, the JOBS Act requires registration if such entities have total assets of more than $10 million and a class of equity security (other than an exempted security) held of record by 2,000 or more persons, regardless of accredited investor status.

securities pursuant to an employee compensation plan in transactions that were exempt from the registration requirements of the Securities Act of 1933 (the "**Securities Act**"). This could allow an unlimited number of shareholders, so long as they received their shares pursuant to an employee compensation plan, and extends the existing limited relief that has applied to the grant of stock options and restricted stock units.

Background

As a way to incentivize their service providers, some private companies rely heavily on the grant of stock options and/or other equity compensation awards to more than 500 holders, which could potentially trigger Exchange Act registration and reporting requirements.

Rule 12h-1(a) of the Exchange Act provides an exemption from Section 12(g) registration for interests and participations in certain types of employee compensation plans (such as stock bonus, stock purchase, profit sharing, pension, retirement and other plans), but the exemption does not cover stock options. Over the years, through a series of no-action letters, the SEC granted exemptive relief on a case-by-case basis to issuers who would otherwise become subject to the Exchange Act due to option grants to more than 500 persons. This relief was focused on ensuring that the issuance of options to more than 500 persons did not result in creating a market for securities in the United States.

In the SEC's 2007 Release 34-56887, the SEC gave broad exemptive relief from Section 12(g) registration for compensatory stock options if, among other requirements, the options were not transferable and were issued in compliance with Rule 701 of the Securities Act.[4] However, the SEC noted in the release that "[t]he exemption for the compensatory employee stock options will not extend to other rights issued in connection with the compensatory employee stock options, such as stock appreciation rights." Also, the relief did not apply to a holder who exercised an option and became a shareholder.

In the years that followed the 2007 release, the SEC extended the exemptive relief for stock options to restricted stock units, but only in response to specific requests, and it was not until earlier this year that the SEC, through a global no-action letter, granted broad exemptive relief from Section 12(g) registration for compensatory restricted stock units. As was the case for stock options, the SEC noted that the relief for restricted stock units was limited to those that met the conditions specified in the no-action letter[5] and did not cover other securities that a company might issue.

Relief under the JOBS Act

The JOBS Act not only raises the Exchange Act registration threshold to 2,000 holders of any class of equity security, but also amends the "held of record" definition in Section 12(g)(5) of the Exchange Act to exclude "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."[6] Such securities would presumably include all forms of equity-based compensation (not just stock options and restricted stock units but also restricted stock and stock appreciation rights) offered under various registration exemptions on which private companies have traditionally relied to grant equity-based compensation to their U.S. and foreign employees, such as Rule 701, Regulation D, Regulation S and the

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[4] This relief is reflected in Rule 12h-1(f) of the Exchange Act.

[5] The conditions are generally similar to those that apply to compensatory stock options under Rule 12h-1(f) of the Exchange Act.

[6] A Senate amendment that would have required the SEC to conduct rulemaking to revise the "held of record" definition in Section 12(g)(5) of the Exchange Act to include beneficial owners was not adopted by the JOBS Act. This means that plans, such as an ESOP (or an employee stock ownership plan), will continue to count as one holder of record.

"no sale" theory under the Securities Act. This means private companies will have more flexibility in granting equity compensation as the number of employees increases, although they will still need to review compliance with Securities Act exemptions and the applicable state and foreign securities laws.

The JOBS Act also directs the SEC to adopt safe harbor provisions that would allow issuers to determine whether holders of their securities received the securities pursuant to an employee compensation plan in exempt transactions. Based on the legislative history of the JOBS Act, the issues that Congress expects the SEC to address when adopting the safe harbor provisions include: the steps issuers can take to obtain comfort that securities are held by persons who received the securities pursuant to an employee compensation plan and whether the issuance of those securities was exempt from registration. The legislative history also indicates that the definition of an "employee compensation plan" should be interpreted broadly and that the exemption should be extended to persons other than the issuers' employees, such as surviving spouses or family members who inherit the securities from the employees.

Effective Date

The provisions of the JOBS Act that reduce executive compensation obligations for EGCs are self-effectuating. However, as noted above, an issuer will not be able to qualify as an EGC if its IPO occurred on or before December 8, 2011. The provisions of the JOBS Act that increase the shareholder threshold for public company reporting and amend the "held of record" definition are also self-effectuating, except that the SEC will need to establish safe harbor provisions regarding the equity compensation exemption, as described above.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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