Report on Authority to Enforce Exchange Act Rule 12g5-1 and Subsection (b)(3)

As Required by Section 504 of the
Jumpstart Our Business Startups Act

This is a Report by the Staff of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.

October 15, 2012

REPORT ON AUTHORITY TO ENFORCE EXCHANGE ACT RULE 12g5-1 AND SUBSECTION (B)(3)

As Required by Section 504 of the Jumpstart Our Business Startups Act

I. Introduction

A. Congressional Mandate

The staff of the U.S. Securities and Exchange Commission (the "Commission") has prepared this report, pursuant to Section 504 of the Jumpstart Our Business Startups Act (the "JOBS Act") [1], on Rule 12g5-1(b)(3) promulgated under the Securities Exchange Act of 1934 ("Exchange Act")[2]. Section 504 of the JOBS Act provides as follows:

> The Securities and Exchange Commission shall examine its authority to enforce Rule 12g5–1 to determine if new enforcement tools are needed to enforce the anti-evasion provision contained in subsection (b)(3) of the rule, and shall, not later than 120 days after the date of enactment of this Act transmit its recommendations to Congress.

B. Issues Related to Rule 12g5-1(b)(3)

As discussed in detail below, Section 12(g) of the Exchange Act requires an issuer of a certain size to register under the Exchange Act and file periodic and current reports.[3] Under Section 12(g), as amended by the JOBS Act, if a company has less than 2,000 holders of record of

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1 Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

2 15 U.S.C. § 78a et seq.

3 15 U.S.C. § 78l(g). Prior to the enactment of the JOBS Act, Section 12(g) of the Exchange Act and the Commission's rules thereunder, required an issuer to register a class of its equity securities if, at the end of the issuer's fiscal year, the securities were "held of record" by 500 or more persons and the issuer had total assets exceeding $10 million. As discussed in more detail in Part IV below, the Act increased the holders of record threshold for issuers who are neither banks nor bank holding companies to either 2,000 holders of record or 500 persons who are not accredited investors, with some additional exclusions.

its equity securities and less than 500 holders of record who are not accredited investors,[4] the company would not trigger the registration and reporting requirements of Section 12(g) of the Exchange Act. Concerns have recently been raised regarding the impact on the requirements to register under Section 12(g) of the creation of special purpose vehicles established to pool investor funds and purchase shares (typically from former employees and early investors) of companies that have not yet undertaken a public offering of their shares.[5] In such a situation, if each special purpose vehicle is treated as a single investor for purposes of Section 12(g) of the Exchange Act, the issuer whose shares were held by such special purpose vehicles could have significantly fewer holders of record than if the individual investors in each special purpose vehicle were counted. Concerns may arise as to whether the special purpose vehicles facilitate evasion of the registration and reporting requirements of Section 12(g), possibly resulting in investors not having access to appropriate disclosure.

C. Scope of the Study

The staff of the Commission's Division of Corporation Finance conducted the study in consultation with staff from the Division of Enforcement, the Division of Trading and Markets, the Division of Risk, Strategy and Financial Innovation, the Division of Investment Management and the Office of the General Counsel.

In conducting this study, the staff examined current Exchange Act Rule 12g5-1(b)(3), its history and origin along with the past record of Commission, staff and court actions relating to the

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4 An accredited investor is defined in Rule 501 of Regulation D. 17 CFR 230.501.

5 See Steven M. Davidoff, Facebook and the 500-Person Threshold, N.Y. Times (Jan. 3, 2011, 4:03 PM), http://dealbook.nytimes.com/2011/01/03/facebook-and-the-500-person-threshold/; Scott D. McKinney, Facebook and the Challenge of Staying Private, Insights: The Corporate & Securities Law Advisor vol 25, no. 2 (2011); See also Letter from Congressman Darrell E. Issa, Chairman, Committee on Oversight and Government Reform, U.S. House of Representatives, to Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission (Mar. 22, 2011).

rule.[6] In addition, the staff examined the Commission's ability to enforce Rule 12g5-1(b)(3) as drafted under various fact patterns and the adequacy of current enforcement tools. Further, the staff analyzed whether any new enforcement tools would assist the Commission in enforcing the rule as written. We note that the scope of this study is limited and does not extend to other potentially important questions regarding registration and reporting triggers.

II. Summary and Background of Rule 12g5-1(b)(3)

A. The Origins of Section 12(g) and Rule 12g5-1

Registration under Section 12(g) of the Exchange Act provides investors with important information about the issuer. If, on the last day of its fiscal year, an issuer reaches the thresholds that require registration under Section 12(g), it has 120 days from the end of its fiscal year to file an Exchange Act registration form with the Commission. This form, typically a Form 10, includes much of the disclosure regarding the company required in a Form S-1, the registration form required by a company in its initial public offering of securities.[7] Among other things, an issuer must provide investors with information about the company's business and its management, management's discussion of the company's financial condition and results of operations, as well as financial statements audited by independent registered public accounting firms. Moreover, Section 13 of the Exchange Act requires companies with a class of securities registered under Section 12 to file current and periodic reports to ensure the provision of important and timely information to investors.[8] These periodic and current reports include an

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6 The staff reviewed, among other things, Commission releases, relevant case law, various media sources and empirical data in filings made on the Commission's Electronic Data Gathering, Analysis, and Retrieval ("EDGAR") system.

7 A Form S-1, along with a Form 10, require disclosure of various items of Regulation S-K [17 CFR 229] and Regulation S-X [17 CFR 210].

8 15 U.S.C. § 78m.

annual report with audited financials on Form 10-K, quarterly reports on Form 10-Q and current reports for certain material events on Form 8-K. All of these forms may be subject to selective review and comment by the staff of the Division of Corporation Finance and are available to the public through the Commission's EDGAR system. Registration and periodic reporting are cornerstones of the Exchange Act's disclosure regime. In addition to periodic and current reports, when a company registers a class of securities under Section 12, the company and certain related persons incur a number of Exchange Act obligations. These obligations include compliance with the proxy rules,[9] the Section 16 short-swing profit provisions,[10] and the Williams Act.[11]

Section 12(g) was not initially part of the Exchange Act when it was adopted in 1934. Only issuers with securities registered under Section 12(b) (securities listed on a national securities exchange) and certain issuers that had conducted a registered offering of securities were required to report under the Exchange Act. Section 12(g) was enacted in 1964 following a multi-year study of the securities business and securities markets commissioned by Congress and conducted on behalf of the Commission in the early 1960s (the "Special Study").[12] Congress

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9 Exchange Act Section 14(a) and corresponding Regulation 14A govern disclosure that must be provided to security holders of Section 12 registered securities when a person is soliciting authority to act as their proxy to authorize a corporate action.

10 15 U.S.C. § 78p.

11 The Williams Act regulates tender offers and other significant acquisitions of public company securities. 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f). It was enacted in 1968 and amended at various points during the 1970s. The Williams Act added the following sections to the 1934 Act:

- Sections 13(d) and 13(g) - reporting by certain beneficial owners;
- Section 13(e) - purchases of securities by the issuer;
- Section 13(f) - institutional investment manager reporting;
- Section 14(d) - third-party tender offers; and
- Section 14(e) - disclosure, procedural, and anti-fraud requirements for all tender offers.

The Commission has adopted a number of rules under each of these subsections.

12 Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 88-95, pt. 3, at 1 (1963) (conducted pursuant to Act of Sept. 5, 1961, Pub. L. No. 87-196 (1961)). Unlike the broader mandate provided by Congress relating to the Special Study, under the JOBS Act, Congress has

tasked the Commission with the Special Study due to concerns about the gap in the existing statutory regime under which companies that did not trade on a national exchange, such as those traded in the over-the-counter market, were not required to register or file periodic reports with the Commission.[13] While securities traded on national securities exchanges[14] were required to register with the Commission pursuant to Section 12(b) of the Exchange Act, there was no statutory registration requirement under the Exchange Act for other securities, such as those that traded in the over-the-counter market.[15] The Special Study acknowledged that registration for companies that traded in the over-the-counter market was appropriate, stating, "[t]here has been widespread agreement on the need to extend to unlisted securities the disclosure and other safeguards applicable to listed securities…".[16] The Special Study sought to develop a recommendation for the scope and standards for registration that would be reasonably reliable and easily enforceable and cover issuers that are "sufficiently significant from the point of view of the

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specifically tasked the Commission in this study to "examine its authority to enforce Rule12g5–1 to determine if new enforcement tools are needed to enforce the anti-evasion provision contained in subsection (b)(3) of the rule".

13 Id. pt. 1, at 3.

14 Section 6 of the Exchange Act provides for registration of National Securities Exchanges. There are currently fifteen securities exchanges registered with the Commission under Section 6(a) of the Exchange Act as national securities exchanges. This includes the Nasdaq Stock Market which converted from an over-the-counter market to a national securities exchange in 2006.

15 The Financial Industry Regulatory Authority ("FINRA") regulates broker-dealers that operate in the over-the-counter market. Many equity securities, corporate bonds, government securities, and certain derivative products are traded in the over-the-counter market. The OTC Bulletin Board ("OTCBB") and Pink OTC Markets, Inc., for example, operate within the over-the-counter market. Under the OTCBB's eligibility rule, companies that want to have their securities quoted on the OTCBB must file current financial reports with the SEC or with their banking or insurance regulators. Pink OTC Markets, Inc. operates an electronic inter-dealer quotation system, known as Pink Quote, that displays quotes and last-sale information for many over-the-counter equity securities. Pink Quote does not require companies whose securities are quoted on its system to meet any eligibility requirements. However, Exchange Act Rule 15c2-11 [17 CFR 240.15c2-11] prohibits a broker-dealer from publishing quotes for a covered over-the-counter security in a quotation medium such as Pink Quote, unless it has first obtained and reviewed limited information about the issuer (submitted to FINRA on a Form 211), subject to certain exceptions and exemptions. See, infra at note 41.

16 Special Study, pt. 9 at 1.

public interest to warrant the regulatory burden to be assumed by the Government and the compliance burden to be imposed on the issuers involved."[17]

Based on a balance of theoretical and practical considerations, the Special Study concluded that the holder of record test would be the most appropriate measure of public interest for imposing statutory disclosure requirements on issuers whose securities trade over-the-counter.[18] The Special Study recommended adding an asset test to avoid imposing Exchange Act reporting obligations on insubstantial issuers for which the burden of compliance would be disproportionate to the public interest served by public disclosure.[19]

Following receipt of the Study, Congress passed amendments to the Exchange Act aimed at, "carry[ing] out the legislative recommendations made by the Securities and Exchange Commission for amendments to the securities acts following the 2-year study of the adequacy, for the protection of investors, of the rules of the stock exchanges and of the securities association which the Congress in 1961 directed the Commission to make."[20] These amendments included Section 12(g) of the Exchange Act, which required an issuer with a class of equity securities held of record by 500 persons or more and with total assets exceeding $1 million to register with the Commission.[21]

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17 Id. pt. 3, at 17.

18 Id. The Special Study examined a variety of factors in analyzing the appropriate criteria for requiring registration of certain stock traded on the over-the-counter market by reviewing a select number of companies and data points, including: Amount of assets, the number of shares outstanding, number of shareholders of record, and number of transfers of record.

19 See Commission Chairman William Cary's remarks in the Report of the Committee on Banking and Currency to Accompany S. 1642, S. Rep. No. 88-379, at 52 (1963) ("Committee Report").

20 H.R. Rep. No. 88-1418.

21 15 U.S.C. § 78l(g)(1); 17 CFR 240.12g5-1. When Section 12(g) was enacted, the asset threshold was set at $1 million. The Commission, by rule, increased the asset threshold to $10 million, which was codified in the JOBS Act. See Jumpstart Our Business Startups Act § 501. In addition, for a two year phase in period, from 1964 until 1966, the threshold for holders of record was 750.

Shortly after Congress enacted Section 12(g), the Commission adopted Exchange Act Rule 12g5-1[22] to define "held of record" and to define "total assets" for purposes of Section 12(g) in 1965.[23] The Commission determined not to require issuers to count as holders of record the separate accounts in which securities are held by brokers, dealers, banks or their nominees for the benefit of other persons. The Commission explained that this would "have the effect of simplifying the process by which companies determine whether or not they are covered by [Section 12(g)]."[24] Rule 12g5-1 provides that:

> [S]ecurities shall be deemed to be 'held of record' by each person who is identified as the owner of such securities on records of security holders maintained by or on behalf of the issuer, subject to certain conditions.

The Commission has the authority under Exchange Act Section 12(g)(5) to define the term "held of record" as it deems "necessary or appropriate in the public interest or for the protection of investors in order to prevent circumvention of the provisions" of Section 12(g).

B. An Overview of How Securities are Held Today

Since 1964 and the advent of Section 12(g) and the rules promulgated by the Commission thereunder, a fundamental shift has taken place in how securities are held in the United States. When Section 12(g) was enacted, most investors in U.S. publicly-traded issuers owned their securities in registered form, which means that the securities were directly registered in the name of a specific investor on the record of security holders maintained by or on behalf of the issuer. Today the vast majority of investors own their securities as a beneficial owner through a securities

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22 17 CFR 240.12g5-1.

23 See Adoption of Rules 12g5-1 and 12g5-2 Under the Securities Exchange Act of 1934, Release No. 34-7492 (Jan. 5, 1965) [30 FR 483].

24 Id.

intermediary,[25] such as a broker-dealer or bank.[26] This is often referred to as holding securities in nominee or "street name." In this system, securities in certificate form are deposited, or "immobilized," with a registered clearing agency acting as a securities depository, with securities transactions reflected as changes in beneficial interest in the immobilized securities rather than changes in record ownership.[27]

Immobilization came about in response to incidents in the late 1960s and early 1970s when the securities industry experienced a "paperwork crisis" that directly or indirectly caused the failure of a large number of broker-dealers. This crisis primarily resulted from: increasing trading volume; inefficient, duplicative and extensively manual clearance and settlement systems; issuance of physical securities certificates; poor record keeping systems; and insufficient

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25 For purposes of Commission rules pertaining to the transfer of certain securities, a "securities intermediary" is defined under Exchange Act Rule 17Ad-20 [17 CFR 240.17Ad-20] as a clearing agency registered under Exchange Act Section 17A [15 U.S.C. § 78q-1] or a person, including a bank, broker, or dealer, that in the ordinary course of its business maintains securities accounts for others in its capacity as such.

26 In 1976, the Commission reported to Congress on the effects of the practice of registering securities in other than the name of the beneficial owner. In its report the Commission stated that 23.7% of shares were held in nominee and street name in 1964 and 28.6% of shares were held in nominee and street name in 1975. Securities and Exchange Commission, Final Report of the Securities and Exchange Commission on the Practice of Recording the Ownership of Securities in the Records of the Issuer in Other than the Name of the Beneficial Owner of Such Securities Pursuant to Section 12(m) of the Securities Exchange Act of 1934 (December 3, 1976). Based on an analysis of available data over the period 2008 through 2010, the Commission's Division of Risk, Strategy and Financial Innovation estimates that over 85% of the holders of securities in the U.S. markets hold through a broker-dealer or a bank that is a Depository Trust Company participant. See also SIFMA Proxy Working Group, Report on the Shareholder Communications Process with Street Name Holders, and the NOBO-OBO Mechanism (June 10, 2010) (reporting that approximately 85% of all exchange-traded shares are today held in street name) (citing Order Approving Proposed Rule Change, as modified by Amendment No. 4, to Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08 to Eliminate Broker Discretionary Voting for the Election of Directors, Release No. 34-60215 (July 1, 2009) [74 FR 33293]. As indicated above, the statistics focus on exchange-traded shares. Access to this data on over-the-counter securities that are not registered pursuant to Section 12(g) or 12(b) or subject to Section 15(d) of the Exchange Act is limited.

27 Immobilization of securities occurs when a securities depository holds the underlying certificate or certificates representing ownership of securities, and transfers of ownership, or trading in securities, are recorded as book entries through increases and decreases in the accounts of securities intermediaries who are participants in the securities depository's system. An issue is partially immobilized (as is the case with most equity securities traded on a national securities exchange) when the positions of participants are immobilized but certificates are still held by certain holders or are available to holders upon request. For more information about immobilization of securities, see Securities Transactions Settlement, Release No. 34-49405 (March 11, 2004) [69 FR 12922] ("Securities Transactions Settlement Concept Release").

maintenance of controls over funds and securities.[28] To address these concerns, Congress amended the Exchange Act in 1975[29] to, among other things, substantially revise Section 15(c)[30] and add Section 17A.[31] The amendments were intended to facilitate the creation of a national system for the prompt and accurate clearance and settlement of securities transactions and to eliminate the negotiable stock certificate as a means of transferring ownership of securities. Concurrently, Section 15(c) provided the Commission with rulemaking authority over brokers and dealers to regulate settlement, payment transfer and delivery of securities in furtherance of investor protection.[32] Consistent with congressional intent, the Commission has encouraged the immobilization of stock certificates through the use of securities depositories. These changes and the move towards immobilization had the effect of decreasing the number of investors who held in registered form and greatly increasing the number of investors who own their securities as a beneficial owner or in street name.[33] This trend impacts Section 12(g) and Rule 12g5-1, as investors who own their securities as beneficial owners or in street name, or through other entities, are not counted as holders of record under Rule 12g5-1.

Unlike a registered owner (or record holder), whose ownership of securities is listed on records maintained by the issuer or its transfer agent, a beneficial owner of securities that holds through a securities intermediary does not own the securities directly. Instead, as a customer of the securities intermediary, the beneficial owner has an entitlement to certain rights associated

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28 Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 92-231 (1971). Congress held extensive hearings to investigate the paperwork crisis and ultimately enacted the Securities Acts Amendments of 1975. See also Securities Transactions Settlement Concept Release supra n. 27.

29 Pub. L. 94-29, 89 Stat. 160 (1975).

30 15 U.S.C. §78o.

31 15 U.S.C. §78q-1.

32 Securities Acts Amendments of 1975, S. Rep. No. 94-75 (1975).

33 Securities Transactions Settlement Concept Release supra n. 27.

with ownership of the securities held by the securities intermediary for the benefit of the beneficial owner.[34] The broker-dealer or bank that purchases securities on behalf of its customers typically holds its securities and those of its customers through a securities depository, which, in turn, designates its nominee to be the registered owner on the issuer's records. In the United States, the Depository Trust Company ("DTC")[35] holds the vast majority of U.S. equity securities for U.S. broker-dealers and banks in the name of its nominee, Cede & Co.[36] In addition to holding securities positions for its customers, some broker-dealers or banks that are participants in a securities depository (sometimes referred to as clearing broker-dealers) also hold securities positions for other broker-dealers, who in turn may hold securities for other broker-dealers or customers.

Issuers may also use transfer agents to facilitate the transfer of shares among holders and maintain the official record of security holders.[37] Transfer agents registered under federal law are required to maintain accurate ownership records, which include the number of record holders of a

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34 See U.C.C. §§ 8-501 to 8-511 (2011) (explaining the securities entitlement of a beneficial owner). See also Securities Transactions Settlement Concept Release supra n. 27; Concept Release on U.S. Proxy System, Release No. 34-62495 (July 14, 2010) [75 FR 42982].

35 DTC, a clearing agency registered with the Commission under Section 17A of the Exchange Act and the largest securities depository in the world, centralizes and automates the securities settlement process. Under the current system, individual investors are incentivized to keep their securities in brokerage accounts due to the risks, additional costs and time delays associated with the physical movement and possession of stock certificates. Similarly, broker-dealers and banks, DTC's primary participants, are incentivized to maintain accounts at DTC where book-entry transactions can be made, avoiding the risks, costs and delays associated with processing physical securities certificates. Investors holding securities in brokerage accounts and broker-dealers maintaining those holdings through accounts at DTC serve to substantially immobilize stock certificates, creating a more efficient and safer market for trading securities.

36 Cede & Co. is the nominee name DTC uses on the records of the issuer.

37 Transfer agents are regulated under both federal and state law. The term "transfer agent" is defined under federal law as any person who engages on behalf of an issuer of securities or on behalf of itself as an issuer of securities in (A) countersigning such securities upon issuance; (B) monitoring the issuance of securities with a view to preventing unauthorized issuance of the securities; (C) registering the transfer of securities; (D) exchanging or converting securities; or (E) transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates. 15 U.S.C. 78c(a)(25). If a transfer agent acts for an issuer of securities registered under Section 12 of the Exchange Act, the transfer agents must be registered under Section 17A of the Exchange Act. 15 U.S.C. 78q-1(c)(1). Transfer agents acting for issuers of securities that are not Section 12 registered are regulated through state corporation, commercial, and principal/agency laws.

class of securities, but are not generally in a position to know the number of beneficial owners (i.e., the number of investors holding in street name).[38]

C. Application of Rule 12g5-1

The definition of "held of record" in Rule 12g5-1, as outlined above, includes only those persons registered on the issuer's records, with the exception of DTC's nominee, Cede & Co. Cede & Co. is not considered a single holder of record for purposes of the Exchange Act's registration and periodic reporting provisions. Instead, each of the accounts of the participants in DTC that hold securities of an issuer is considered a record holder.[39] Under Rule 12g5-1, a single broker-dealer is counted as one holder of record, even though it may hold securities on behalf of more than one individual beneficial owner. Consequently, the majority of investors owning securities of widely traded companies are not individually reflected on the issuers' records and are not counted under the current definition of "held of record." In addition, market participants and shareholders may hold through other forms of holding that appear on the company's stock record book as one record holder, when such record holder holds on behalf of many beneficial owners. In these ways, issuers with more than 2000 beneficial owners, but less than 2000 holders of record, can be actively traded in the over-the-counter markets or in private secondary markets, without triggering the threshold requirements to report under the Exchange Act.[40] Investors in

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[38] 17 CFR 240.17Ad-6. In addition, transfer agents do not currently keep track of whether a record holder meets the requirements of Rule 501 of the Securities Act [17 CFR 230.501] to be considered accredited investors and do not currently have systems to track whether shares were obtained in a crowdfunding transaction or pursuant to an employee compensation plan in transactions exempted from the registration requirements of Section 5 of the Securities Act. As discussed below in Part IV, pursuant to the JOBS Act, such holders are excluded from the number of record holders used to measure the Section 12(g) threshold. The Commission's Division of Trading and Markets is currently reviewing the federal transfer agent rules to determine whether to recommend to the Commission modernizing the rules to better reflect changes in technology and the transfer agent industry.

[39] See the Division of Corporation Finance's Compliance and Disclosure Interpretations on Exchange Act Rules (September 30, 2008), at Section 152 (Rule 12g5-1), Question No. 152.01.

[40] It should be noted that given the percentage of securities of issuers that are immobilized and trade through DTC, there are also numerous exchange listed companies that have a small number of record holders.

these securities do not necessarily have the disclosures provided by Exchange Act reporting, though generally there must be some information available to a broker-dealer in order to initiate or resume publication of a price quote in a security. [41]

III. Rule 12g5-1(b)(3)

Realizing that forms of holding could be abused to avoid triggering the thresholds that require registration pursuant to Section 12(g), the Commission adopted Rule 12g5-1(b)(3) to prevent circumvention of Section 12(g).[42] Rule 12g5-1(b)(3) states that:

> [i]f the issuer knows or has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of Section 12(g) or 15(d)[43]

However, companies whose securities are listed on a national securities exchange are required to be registered pursuant to Section 12(b), and to comply with the reporting and other obligations under the Exchange Act, regardless of the number of record holders.

41 Exchange Act Rule 15c2-11 prohibits a broker-dealer from publishing quotes for a covered over-the-counter security in a quotation medium unless it has first obtained and reviewed certain limited information about the issuer (submitted to the FINRA on a Form 211), subject to certain exceptions and exemptions. This information is much less comprehensive than the disclosure required by Section 12(g) and Section 15(d) of the Exchange Act and does not have to be periodically updated. There are certain instances where a broker-dealer may publish a quotation without first reviewing information about the issuer. Under the "piggyback" exception to Rule 15c2-11, a broker-dealer does not have to comply with the information review requirements of the rule if the security has been the subject of quotations on at least 12 business days during the previous 30 calendar days, with no more than four consecutive business days elapsing without a quotation. A broker-dealer can "piggyback" on either its own quotations or other broker-dealers' previously published quotations, without reviewing the required information under the rule unless there is a lapse in quotation activity of more than four consecutive business days. Under the "unsolicited order exception", a broker-dealer may also publish or submit a quotation without reviewing information about the issuer where the quotation (i) is solely on behalf of a customer and represents that customer's indication of interest, and (ii) does not involve the solicitation of that interest by the broker-dealer publishing the quotation. It should be further noted that the "unsolicited order exception" does not apply to a quotation consisting of both a bid and an offer, each of which is at a specified price, unless the quotation medium specifically identifies the quotation as representing such an unsolicited customer interest.

42 Exchange Act Section 12(g)(5) provides express authority for the Commission to adopt rules and regulations defining the terms "total assets" and "held of record" to prevent circumvention of Section 12(g).

43 Section 15(d) of the Exchange Act requires issuers to file periodic reports after a registration statement is declared effective under the Securities Act. This obligation continues until the end of the fiscal year in which the Securities Act registration statement became effective and the issuer has fewer than 300 record holders (or 1,200 record holders for banks and bank holding companies) of the class of securities offered under the Securities Act registration statement or the number of record holders of that class falls below 500 and the company's assets have been no more than $10 million at the end of each of its last three fiscal years. See Section 15(d) of the Exchange Act [15 U.S.C. 78o] and Rule 12h-3 [17 CFR 240.12h-3]. While Rule

of the Act, the beneficial owners of such securities shall be deemed to be the record owners thereof.

The rule has been described by commentators as "a catch-all provision that is aimed at deterring the organization of holding companies, subsidiaries or trusts for the primary purposes of avoiding registration."[44] Rule 12g5-1(b)(3) does not address the Commission's ability to require registration of a class of securities where the number of persons that fall within the definition of "held of record" does not trigger the Exchange Act reporting requirements under Section 12(g), even if the number of beneficial owners, level of trading interest, scope of operations and other factors may indicate that registration is appropriate in the public interest or needed to protect investors.

Rule 12g5-1(b)(3) has two primary legal elements. First, there must be a form of holding that exists primarily to circumvent the provisions of Section 12(g) or 15(d) of the Exchange Act. Second, an issuer must know or have reason to know that a form of holding was being used primarily to circumvent the provisions of 12(g) or 15(d). Both elements must be present for the Commission to pursue a violation.[45]

Rule 12g5-1(b)(3) has been invoked by the Commission or in private litigation sparingly and little precedent interpreting the rule is available.

A. Commission Action

12g5-1 and subsection (b)(3) apply to Section 15(d), since Section 15(d) only applies to issuers that have taken the affirmative action to file a registration statement under the Securities Act and undertake the consequent reporting obligation, it is not the primary focus of this study.

44 Louis Loss and Joel Seligman, Fundamentals of Securities Regulation (3rd Ed. 2005).

45 An issuer that does not know or have reason to know that a form of holding was used primarily to circumvent the Exchange Act may not be liable for past violations, but would nevertheless be required to register a class of securities pursuant to Section 12(g), or to file reports and other information pursuant to Section 15(d), if the legal elements are met.

The Commission has not addressed the scope of Rule 12g5-1(b)(3) at length. Both the proposing and adopting releases for the rule contain little more than a recitation of the rule text.[46] The most extensive discussion by the Commission is found in the order for In the Matter of Bacardi Corporation.[47]

The Bacardi Corporation ("Bacardi") was a Section 12(g) registrant and had recently effected a reverse stock split to reduce the number of holders of its common stock. Upon effecting the reverse stock split, Bacardi filed a Form 15 indicating it had less than 200 shareholders of record, allowing Bacardi to deregister its class of common stock from Exchange Act registration in reliance on Exchange Act Rule 12g-4.[48] Rule 12g-4 allows an issuer that has a class of securities registered under Section 12(g) to terminate that registration when either the number of persons that hold of record of that class falls below 300 (without regard to the issuer's assets), or the number of persons that hold of record of that class falls below 500 and the issuer's assets have not exceeded $10 million at the end of each of its last three fiscal years.[49]

A Bacardi shareholder challenged the company's certification, on the Form 15 filed with the Commission to deregister the company's common stock, that it had less than 200 common stockholders of record. The shareholder claimed that, in calculating the number of holders of record, Bacardi ignored the 238 revocable trusts that he established and to which he had transferred Bacardi stock. Bacardi had stated in the Form 15 filed with the Commission to

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46 "Held of Record" and "Total Assets", Proposed Definitions, Release No. 34-7426 (Sept. 15, 1964) [29 FR 13488] (adopted in Release No. 34-7492 (Jan. 5, 1965) [30 FR 483]).

47 Release No. 34-27255 (Sept. 18, 1989). The Commission-ordered proceedings were ultimately dismissed in 1992 as a result of a settlement agreement between the shareholder and Bacardi. Release No. 34-30681 (May 8, 1992).

48 17 CFR 240.12g-4.

49 Id.

deregister its securities that it did not include these trusts in its calculation because they had been recently established for the "express purpose of attempting to prevent…deregistration."

On June 9, 1988, the Commission issued an order directing that an evidentiary hearing be held before an administrative law judge to determine whether Bacardi's certification was accurate.[50] In a motion to expand the scope of the Commission-ordered hearing, Bacardi argued that the Commission must determine whether the "trusts were merely a device to prevent [Bacardi's] deregistration since, in [Bacardi's view], that fact would preclude them from being counted as holders of record." Citing Rule 12g5-1(b)(3), Bacardi characterized the shareholder's transfer of stock to the trusts for the purpose of preventing deregistration as a "circumvention" of Section 12(g).[51]

The Commission disagreed with Bacardi's argument, refusing to expand the scope of the hearing. In doing so, the Commission noted that Rule 12g5-1(b)(3) "is directed at issuers who seek to evade registration" and "[i]t is not a tool to help issuers deregister."[52] One could thus view Rule 12g5-1(b)(3) as primarily directed at preventing an issuer's circumvention of the registration provision of 12(g) and not intended to extend to the deregistration process generally.

B. Staff Action

1. Section 12(h) Orders

Guidance from the staff regarding Rule 12g5-1(b)(3) has also been limited. Although not directly addressing Rule 12g5-1(b)(3), some exemptive orders under Section 12(h) of the Exchange Act have addressed similar issues that Rule 12g5-1(b)(3) is designed to address. Section 12(h) grants the Commission broad authority to exempt by rule and regulation, or upon

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50 In the Matter of Bacardi Corporation, Release No. 34-25795 (Sept. 18, 1989).

51 Id.

52 Id.

application of an interested person, by order, after notice and opportunity for hearing, in whole or in part any issuer or class of issuers from the provisions of Section 12(g) of the Exchange Act "if the Commission finds, by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors."[53] The Commission has delegated authority to the Director of the Division of Corporation Finance to grant exemptions under Section 12(h).[54]

Congress added the exemptive authority in Section 12(h) of the Exchange Act to provide the Commission with "flexibility in the administration" of Section 12(g) and other reporting provisions of the Exchange Act applicable to securities traded in the over-the-counter market.[55] To this end, Congress provided the Commission with "ample authority to modify, and provide exemptions from, the statutory requirements for different issuers on the basis of the number of shareholders, trading interest in their securities, nature and extent of their business activities, income, asset size, or other relevant considerations."[56] The Committee Report also recognized that strict application of numerical triggers may not always be consistent with Congress's desire to balance the public benefits of reporting with the burdens on reporting companies, particularly smaller companies.[57]

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53 15 U.S.C. § 78l(h). In addition, Congress gave the Commission general exemptive authority in Section 36 of the Exchange Act.

54 17 CFR 200.30-1(e)(7).

55 See Committee Report supra n. 19 at 63.

56 Id.

57 The Senate Committee observed: "Under the Investment Company Act of 1940, Congress set 100 shareholders as the standard for measuring the public interest. Such inclusive coverage might, however, create a burden on issuers and the Commission unwarranted by the number of investors protected, the size of companies affected, and other factors bearing on the public interest. Unlike the Securities Act, which requires filing only on the occasion of an offering, the Exchange Act requires at least annual filings. It is therefore necessary on purely practical grounds to limit in some manner the number of issuers required to comply, so that the flow of reports and proxy statements will be manageable from the regulatory standpoint

In implementing the exemptive authority provided in Section 12(h), the Commission and its staff balance the factors in Section 12(h) listed above, with no single criterion alone serving as the basis for granting an exemption.[58] The criteria set forth in Section 12(h) serve as "guidelines" and the Commission and its staff look at the particular circumstances of each matter to determine whether an exemption meets the standards in Section 12(h).[59]

In a recent application for relief under Section 12(h) by BF Enterprises, the issue of the form of holding of securities for purposes of registration arose.[60] In BF Enterprises, a single beneficial owner created 500 trusts and transferred his ownership of shares of the issuer's common stock to those trusts for the sole purpose of attempting to cause the company to register its class of common stock under Section 12(g).[61] The company had no involvement with the creation or administration of the trusts. The staff determined that relief, pursuant to Section 12(h), was warranted in this instance because, among other factors, "[t]his increase in the number of owners appearing on the company's books does not reflect a growth in public holders that requires the protections of Exchange Act reporting; nor is this increase 'sufficiently significant

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and not disproportionately burdensome on issuers in relation to the national public interest to be served." Id. at 19.

58 As stated in Section 12(h) of the Exchange Act, the factors include, "The number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, and income or assets of the issuer." 15 U.S.C. § 78l(h) (2006).

59 See, e.g., In the Matter of The National Dollar Stores, Ltd., Admin. Proc. File No. 3-1212, 81-79 (Sept. 11, 1968) (explaining that "the criteria [set forth in Section 12(h)] are designed merely to provide us with guidelines in considering the basic tests" of whether an exemption is not inconsistent with the public interest or the protection of investors; and concluding that limited, conditional relief warranted "under the circumstances"); In the Matter of Lake Ontario Concrete Limited, Admin. Proc. File No. 3-2615 (May 23, 1973) (where Commission recognized "unusual combination of circumstances" in granting limited exemption); and In the Matter of Multi Benefit Realty Fund, et al., Admin. Proc. File No. 3-4400 (Mar. 11, 1976) (where four partnerships with aggregate assets of $183 million and 5,600 limited partners denied exemption despite lack of trading interest in applicants' securities and purported sophistication of investors because those factors were "outweighed" by the applicants' size and by the number of investors involved, with the Commission specifically noting "[t]hough significant, trading interest is not the sole consideration to be looked at in these matters").

60 Order Granting an Application of BF Enterprises, Inc. Under the Securities Exchange Act of 1934, Release No. 34-66541 (Mar. 14, 2012) [77 FR 15148].

61 Id.

from the point of view of the public interest to warrant the regulatory burden to be assumed by the Government and the compliance burden to be imposed on the [issuer] involved.'"[62]

In addition, in two no-action letters from the 1970s, the staff of the Division of Corporation Finance addressed certain profit-sharing plans. Noting counsel's opinions that the profit-sharing plans were not attempts to circumvent Section 12(g) registration, the staff stated that it would not recommend enforcement action against the plans for violating Section 12(g).[63]

2. Staff Report

In a 1992 report to the Commission examining the manner in which investment companies and other pooled securities are regulated, the staff of the Division of Investment Management briefly discussed Rule 12g5-1(b)(3) in the context of recommended legislative changes to the Investment Company Act[64] to allow the Commission to grant, by rule or order, permission to an operating foreign investment company to register under the Investment Company Act and to exempt it from one or more provisions of the Act.[65]

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62 Id.

63 See H.C. Prange Company (Feb. 20, 1978); and Wawa, Inc. (Jan. 2, 1976).

64 15 U.S.C. § 80a et seq.

65 Division of Investment Management, U.S. Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulation 213 (1992). The pertinent section of the report analyzed a number of approaches to remove unnecessary barriers to cross-border sales of investment companies. The report noted that the proposal, which was not implemented, would require a foreign fund not otherwise excepted from the definition of an investment company to register if: it made a public offer using U.S. jurisdictional means; it had used U.S. jurisdictional means in connection with any U.S. offering of its securities and had more than 100 shareholders of record who are U.S. residents; or it had taken steps to facilitate secondary market trading in its securities in the United States either by listing its shares on a securities exchange or having its shares quoted by any securities information processor registered under the Exchange Act or by other means, and had more than 100 shareholders of record who are U.S. residents. In order to alleviate some of the problems faced by foreign funds in identifying and monitoring ownership by U.S. residents, the report noted a shareholder of record standard could substitute for the beneficial owner standard used in Section 7(d) of the Investment Company Act. The staff of the Division of Investment Management noted it could look, in part, to Rule 12g5-1 for the definition of "held of record" and noted the purpose of its anti-evasion provision:

> Rule 12g5-1 provides that securities are deemed to be "held of record" by each person who is identified as the owner of the securities on the records of security holders maintained by or on behalf of the issuer, subject to certain qualifications. These qualifications pertain to specific circumstances under which questions

C. Case Law Addressing Scope of Rule 12g5-1(b)(3)

The staff is aware of only one court opinion interpreting Rule 12g5-1(b)(3). In the case of Tankersley v. Albright, the United States Court of Appeals for the Seventh Circuit examined a district court holding on whether or not the Tribune Company ("Tribune") had complied with the registration requirements of Section 12(g) of the Exchange Act.[66] At issue was a trust with approximately 151 beneficiaries which controlled 53 percent of the outstanding common stock of Tribune. The defendants in the case, who were beneficiaries of the trust as well as holders of non-trust interests in Tribune stock counterclaimed that the trust and Tribune were in violation of the Exchange Act because the trust was not an ordinary trust, but instead a voting trust, deposit agreement or other arrangement. Under Rule 12g5-1(a)(2), an ordinary trust is considered a single holder of record, whereas under Rule 12g5-1(b)(1) a voting trust, deposit agreement or similar arrangement receives "look-through" treatment and each record holder of the voting trust is counted as a record holder of the issuer.[67] Therefore, if one looked through to the beneficiaries of the trust, Tribune would have more than 500 shareholders of record. The court determined that the trust was not a voting trust and additionally noted that the employee's trust was not a "device created to avoid having the employee beneficiaries included as shareholders of record."[68] The court noted that the trust "clearly serve[d] other important purposes."[69] In other words, the court determined that the form of holding was not created or being used primarily to circumvent the

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could arise regarding the method of calculation. They also seek to prevent the use of artificial calculations as a means of circumventing the statute.

66 Tankersley v. Albright, 514 F.2d 956 (7th Cir. 1974).

67 17 CFR 240.12g5-1(b)(1).

68 Tankersley v. Albright, 514 F.2d at 969.

69 Id. at 970.

provision of 12(g) or 15(d) of the Exchange Act, despite the fact that the trust reduced the number of persons that held of record significantly.

D. Potential Interpretive Issues in Establishing Violations based on the Rule

There are several interpretive issues that could arise in Commission enforcement cases alleging violations based on Rule 12g5-1(b)(3). The first element, "that the form of holding securities of record is used primarily to circumvent the provisions of Section 12(g)" raises a question as to how the rule should apply in situations where neither the issuer nor an insider or controlling shareholder of the issuer is involved in creating or administering the form of holding. In determining if a form of holding is being used primarily to circumvent registration, it is important to remember that registration pursuant to Section 12(g) is an issuer requirement. In other words, the responsibility to register is on the issuer, regardless of the actions of a market participant or shareholder. The staff acknowledges there may be investor incentives to a company remaining private, such as keeping certain information non-public,[70] particularly prior to the time an issuer registers an offering under the Securities Act, or the cost savings associated with not being subject to the registration requirements of Section 12(g). However, in light of the fact the registration requirement rests with the issuer, situations where a form of holding would be used primarily to circumvent the burden imposed on the issuer by Exchange Act registration and reporting without issuer involvement of some level would appear to be limited. Investors that are not insiders, and that do not otherwise have sufficient bargaining power to obtain information, benefit from the disclosure requirements that come from Section 12 registration and Exchange

[70] See e.g., Joan Farre-Mensa, 2011, Why are Most Firms Privately Held?, New York University and Harvard Business School working paper. The empirical analysis shows that there are disclosure costs related to revealing information to competitors. There is also evidence that private companies have less myopic investment strategies compared to their public peers, and are more sensitive in responding to new investment opportunities. See Asker, Farre-Mensa, and Ljungqvist, 2011, Comparing the Investment Behavior of Public and Private Firms, New York University and Harvard Business School working paper.

Act reporting and would generally have little incentive to prevent an issuer from reaching the required thresholds.[71] Therefore, it seems reasonable to assume that the "primarily to circumvent" element of Rule 12g5-1(b)(3) would not ordinarily be met without some involvement by the issuer, insiders or controlling stockholders. We note that the Bacardi holding as well as the decision in Tankersley v. Albright could be viewed as supporting such a conclusion. However, such a determination would require a facts and circumstances inquiry.

Furthermore, the staff notes that a separate provision, Rule 12g5-1(b)(1), addresses voting trusts, deposit agreements or similar arrangements in which shareholders form vehicles for holding securities without issuer involvement. In such situations, the rule requires issuers to "look through" the holders of record of such trust or agreement in some circumstances.[72] This supports the view that Rule 12g5-1(b)(3) is not primarily directed at shareholders or market participants that create special forms of holding on their own accord, as such arrangements would be generally covered by Rule 12g5-1(b)(1). However, the two paragraphs are not necessarily mutually exclusive, and Rule 12g5-1(b)(1) could be viewed as addressing a specific situation involving specific forms of holding, whereas Rule 12g5-1(b)(3) could apply more generally.

In addition, there could be questions about what the word "primarily" means in situations where there may be more than one plausible use for a form of holding. While the form of holding may contribute to circumvention, such circumvention may not be the sole reason for the form of holding. For example, in the context of a special purpose vehicle in which numerous beneficial owners hold through the vehicle, thereby appearing on the company's records as only one record holder, it might be possible to assert the form of holding is used to avoid triggering rights of first

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71 Holders with contractual information rights or other access to information may benefit from deferring registration under the Exchange Act, to the detriment of other investors, by taking advantage of such information asymmetry.

72 17 CFR 240.12g5-1(b)(1).

refusal or other contractual transfer restrictions common in private companies, to earn fees, to provide a service to clients, for tax or liability structuring or for some other purpose other than to circumvent Section 12(g). In such cases, the Commission would need to demonstrate that circumvention is a primary purpose, not just an ancillary effect, of the form of holding, with the ultimate determination likely to be based on specific facts and circumstances.

Similarly, Rule 12g5-1(b)(3)'s requirement that the issuer knew or had reason to know of the form of holding and the primary purpose of its use raises questions about how the rule should apply when the issuer had something less than actual knowledge. The staff notes that the requisite mental state of "knows or has reason to know" appears most similar to a negligence-type standard.[73] Such a standard would focus on an objective determination and tend to make the inquiry less subjective. Under such a construction, an issuer could be found in violation of Section 12(g) absent proof it actually knew the form of holding was being used to circumvent. For example, if there is evidence that the issuer was presented with facts but ignored them or chose to turn a blind eye to certain facts or should have made a reasonable inquiry or inference from the facts known to it, it is possible the issuer "has reason to know." Again, issuer involvement would play a role in determining if this element was met, as involvement at some level would result in knowledge or a reason to know. Absent any involvement by an issuer, it

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[73] Because the staff is not aware of any direct precedent interpreting this standard in the Rule 12g5-1(b)(3) context, an analogy to Exchange Act Rule 14e-3(a), which uses the same language in the insider trading context may be relevant. Rule 14e-3 prohibits any person who is in possession of material nonpublic information relating to the commencement of a tender offer, acquired directly or indirectly from either the bidder or the target company, from trading in target company securities. It also makes unlawful passing on any such information where it is reasonably foreseeable that the recipient will trade. 17 CFR 240.14e-3. The adopting release for Rule 14e-3(a) in 1980 explains:

> In light of the comments received, the "knows or has reason to believe" standard embodied in the November proposal was replaced with a "knows or has reason to know" standard. This revision should not be construed to indicate that the person who trades or causes a transaction does not necessarily have a duty of inquiry with respect to the information and its source.

Tender Offers, Release No. 34-17120 (Sept. 4, 1980) [45 FR 60410] at n.36.

would be much harder to prove this element of the rule. Therefore, Rule 12g5-1(b)(3) may be applicable only in limited circumstances.

IV. Impact of the JOBS Act

A. Increase in Thresholds by Title V and VI of the JOBS Act.

Prior to the enactment of the JOBS Act, Section 12(g) of the Exchange Act and the Commission's rules thereunder required an issuer to register a class of its equity securities if, at the end of the issuer's fiscal year, the securities were "held of record" by 500 or more persons and the issuer has total assets exceeding $10 million. Title V of the JOBS Act amended Section 12(g) of the Exchange Act to increase the record holder threshold for issuers who are neither banks nor bank holding companies for registration under Section 12(g) to either 2,000 persons who held of record or 500 persons who are not accredited investors.[74] Title VI of the JOBS Act creates specific threshold requirements for banks and bank holding companies, increasing the threshold to 2,000 persons who hold of record.[75]

In addition, Section 502 of the JOBS Act amended Section 12(g)(5) of the Exchange Act to exclude securities held by those who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of Section 5 of the Securities Act from inclusion in the number of persons who hold of record.[76] Finally, Section 303 of the JOBS Act adds a new subsection 12(g)(6) that requires the Commission to adopt a rule

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74 Jumpstart Our Business Startups Act § 501. Section 501 of the JOBS Act also amended Section 12(g) to raise the statutory asset threshold from $1 million to $10 million to conform with changes that the Commission had previously undertaken by rule.

75 Jumpstart Our Business Startups Act § 601.

76 Section 503 of the JOBS Act requires Commission rulemaking to provide a safe harbor for the determination of whether such a holder is to be excluded. Such safe harbor is currently being drafted by the staff.

excluding securities acquired pursuant to a crowdfunding offering[77] from counting toward the Section 12(g) threshold.[78]

Increasing the threshold and excluding securities acquired pursuant to crowdfunding and employee compensation plans from the definition of "held of record" could have an impact on the application of Rule 12g5-1(b)(3) in two ways. First, the provisions have the overall effect of reducing the number of situations in which issuers will be required to register under Section 12 of the Exchange Act. If an issuer does not trigger the reporting requirements of Section 12(g) until it exceeds 1999 persons who hold of record or 499 investors who hold of record and are not accredited, and the issuer may exclude securities held by record holders who received the securities pursuant to an employee compensation plan in an unregistered transaction or those record holders who acquired the securities pursuant to an exempt crowdfunding offering, the motivation for issuers, insiders or controlling shareholders seeking to avoid registration to use forms of holding primarily to circumvent Exchange Act reporting requirements may decrease. However, it is difficult to predict whether companies will find themselves up against the new higher thresholds. Some observers have suggested that hedge funds will increase in size as a result of the increase in the threshold for record holders.[79] Even so, it is not clear if such an increase will lead to the use of forms of holding to obfuscate the number of holders of record in order to circumvent the requirements of Section 12(g).

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77 "Crowdfunding" refers to the ability of a company to raise limited amounts of capital from a large pool of investors. The JOBS Act amends Section 4 of the Securities Act to exempt offers and sales from the requirements of Section 5 of the Securities Act when the amount of securities offered is $1 million or less, provided that individual investments do not exceed certain thresholds and the issuer satisfies other conditions in the JOBS Act, some of which require rulemaking by the Commission.

78 Jumpstart Our Business Startups Act § 303.

79 Maria Lokshin, Hedge Funds Will Grow in Size As Result of JOBS Act, Professor Says, Securities Law Daily, May 9, 2012.

Second, these changes may also impact the ability of issuers, transfer agents, brokers and the staff to accurately track the number of persons who hold of record for purposes of the Section 12(g) threshold. Prior to enactment of the JOBS Act, an issuer determined the number of persons identified as the owner of such securities on its records of security holders, and did not need to attempt to determine other information about the holder in order to evaluate whether or not Exchange Act registration was required. Subsequent to the JOBS Act, an issuer will need to be able to differentiate between record holders who are accredited investors and those who are not accredited investors, record holders who acquired securities through crowdfunding and record holders who acquired securities pursuant to certain employee compensation plans. It remains an open question as to how market participants will develop systems to address this issue and lower the possibility of error in their calculations of the number of holders or investor status.[80]

B. Empirical Data On Companies That Would Be Subject To Section 12(g) Under The New Holder Of Record Threshold

The Division of Risk, Strategy, and Financial Innovation analyzed currently available data in order to determine the potential impact of the JOBS Act on the number of issuers of equity securities with a reporting obligation to the Commission.[81] According to this research, the increase in the threshold for holders of record could have a substantial impact on current non-reporting companies. The ability to measure the precise impact is limited due to limited data

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[80] For instance, additional controls and procedures may be necessary to allow for an accurate count of persons in these various categories in order to determine who is a record holder for purposes of the Exchange Act registration requirements. In addition, the rules and regulations that the Commission must adopt to implement the various provisions of the JOBS Act, such as rules and regulations regarding secondary transfers of shares acquired through crowdfunding transactions, will have an impact on the way in which the number of holders of record are counted.

[81] The Division of Risk, Strategy and Financial Innovation collected information on the number of shareholders of record, which is disclosed in annual filings by SEC reporting companies. Issuers of asset-backed securities were excluded from the analysis. Data was collected using a software program that electronically parsed the filings to extract the shareholder of record number. This number was then compared to the shareholder number reported by Compustat (a data vendor). In the event of a discrepancy between the two numbers or if Compustat did not cover a reporting company, the filing was manually reviewed to collect the shareholders of record number

available on issuers that do not report with the Commission, including any future financing needs to be met through the sale of stock that may affect the number of holders of record. In particular, it is not possible to predict the number of current non-reporting companies who would have triggered a future registration requirement under the old threshold of 500 record holders, but who can now delay registration under the new threshold of 2,000 record holders. However, the staff applied the new threshold of 2,000 holders of record to the existing set of reporting companies to examine how current reporting companies might have been affected by a different threshold requirement.[82] In calendar year 2011, there were approximately 2,983 companies with a class of securities registered under Section 12(g). Shareholder of record data was available for 2,524 of these companies. Of these 2,524 companies, only 318 companies had more than 2,000 shareholders of record. Based on this data, only 13% of current Section 12(g) registrants would be required to initially register with the Commission pursuant to the new thresholds of Section 12(g) today.[83] The remaining 87% of current Section 12(g) registrants would not be mandated to register and make the disclosures provided by Exchange Act reporting today[84] and while generally there must be some information available to a broker-dealer in order to initiate or resume publication of a price quote in a security, this information is much less comprehensive

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82 As noted above, along with the 2,000 holders of record threshold, the JOBS Act also created a 500 non-accredited investor record holder threshold for Section 12(g) registration and reporting. It is not possible to separate accredited from non-accredited holders based on historic information as such data was not required to be disclosed.

83 While they would not meet the new threshold which would require registration under Section 12(g), current registrants must meet the requirements for deregistration before they can cease their registration and reporting requirement. The deregistration requirements, other than for banks and bank holding companies, were not changed by the JOBS Act.

84 It should be noted that a significant subset of companies may still choose to voluntarily register under Section 12(g). Currently, there are 1,321 companies who are registered under Section 12(g) even though they have less than 300 holders of record and hence, appear to be eligible to deregister. In addition, companies who want to have their securities listed on a national securities exchange must register such securities pursuant to Section 12(b) of the Exchange Act, and companies that file registration statements that go effective under the Securities Act must comply with the reporting requirements of Section 13 of the Exchange Act pursuant to Section 15(d) thereof.

than the disclosure required by Exchange Act reporting.[85] Since only 13% of current Section 12(g) registrants would be required to initially register, application of Rule 12g5-1(b)(3) may be less of a concern for issuers who have yet to register, as they will be less likely to reach the threshold for all holders of record.

V. Enforcement of Rule 12g5-1(b)(3)

A. Tools Available to the Commission to Enforce Rule 12g5-1

In order to determine if new enforcement tools are needed to enforce Rule 12g5-1(b)(3), the staff reviewed its current enforcement tools. The Division of Enforcement derives its authority to investigate potential violations of Section 12(g) of the Exchange Act and the rules thereunder, including Rule 12g5-1(b)(3), from Section 21(a) of the Exchange Act, which states: "[t]he Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of this Chapter, the rules or regulations thereunder."[86]

As a practical matter, enforcement investigations are conducted largely by:

- reviewing and analyzing documents, and
- interviewing witnesses to the events or transactions at issue.

Enforcement staff frequently conduct investigations through voluntary requests for documents, interviews, or other information from individuals and entities. Where voluntary requests are not sufficient or appropriate, Section 21(b) of the Exchange Act provides that:

> [f]or the purposes of any such investigation . . . any member of the Commission or any officer designated by it is empowered to administer oaths and

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85 See supra n. 41.

86 15 U.S.C. § 78u.

affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any [documents] . . . relevant or material to the inquiry.[87]

Separately, Section 17(b) of the Exchange Act requires that records of registered broker-dealers, transfer agents, and other entities identified in Section 17(a) must be made available for examination by representatives of the Commission.[88] Similar provisions allow Enforcement staff to require production of records from registered investment advisers and investment companies.[89] Enforcement staff use these provisions to gather records promptly from entities registered with the Commission. Finally, additional procedures for conducting investigations are laid out in the Commission's Rules Relating to Investigations[90] and in the Division's Enforcement Manual, which is publicly available on the Commission's website.[91]

If it appears to the staff that a person or entity has violated or is about to violate the securities laws, the Division of Enforcement may recommend that the Commission pursue an action against the alleged violators. Under Section 21(d) of the Exchange Act, the Commission may bring a civil injunctive action in the proper United States District Court and may seek certain sanctions and remedies including civil penalties, disgorgement, pre-judgment interest, prohibitions on serving as an officer or director of a public company or from participating in an offer of penny stock, and other equitable relief. Alternatively, under Section 21C of the Exchange Act, the Commission may institute a cease-and-desist proceeding before an administrative law

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87 Id.

88 15 U.S.C. § 78q.

89 See generally, Section 204 of the Investment Advisors Act of 1940 and rules thereunder and Section 31 of the Investment Company Act of 1940 and rules thereunder. 15 U.S.C. § 80b-4; 15 U.S.C. § 80a-31.

90 17 CFR 203.1-.8.

91 Securities and Exchange Commission Division of Enforcement, Enforcement Manual, U.S. Securities and Exchange Commission (Mar. 9, 2012), http://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

judge.[92] Section 21B of the Exchange Act authorizes the Commission to seek civil penalties in a cease-and-desist proceeding,[93] and other provisions, including Sections 15(b)[94] and 17A[95] of the Exchange Act, authorize the Commission to seek suspensions or bars from participating in the securities industry. Finally, Section 21(a) of the Exchange Act authorizes the Commission to publish information about investigations even if no enforcement action is taken.[96]

Any investigation into potential violations based on Rule 12g5-1(b)(3) would rely on these authorities to gather information relevant to each of the elements of the rule, and to pursue wrongdoing, if any is discovered. Thus, the staff could bring its investigative techniques to bear on the following questions:

- How many holders of record does the issuer have?
- What are the forms in which securities of such issuer are held and are any such forms of holding used primarily to circumvent the registration provisions of Section 12(g) or the reporting provisions of Section 15(d) of the Exchange Act?
- Does the issuer know or have reason to know that the form of holding is used primarily to circumvent the registration provisions of Section 12(g) or the reporting provisions of Section 15(d) of the Exchange Act?

1. How many holders of record does the issuer have?

The Division of Enforcement has the authority to request or subpoena records from the issuer or the issuer's transfer agent related to the issuer's shareholder lists and any documents used to record and track ownership in a company or that would evidence who has been issued

92 15 U.S.C. § 78u-3.

93 15 U.S.C. 78u-2.

94 15 U.S.C. 78o.

95 15 U.S.C. 78q-1.

96 15 U.S.C. 78u.

securities of the company in question. Whether the threshold number is 500 or 2000, the exercise of counting holders is the same. However, pursuant to the JOBS Act, in order to establish a violation based on Rule 12g5-1(b)(3), the Division of Enforcement must also determine whether the holders are accredited investors, as Section 501 of the JOBS Act creates a separate holder of record threshold for non-accredited investors.[97] In addition, the Division of Enforcement must determine whether the securities were acquired pursuant to an employee compensation plan in transactions exempt from registration under Section 5 of the Securities Act or pursuant to a crowdfunding transaction, as, pursuant to Sections 502 and 303 of the JOBS Act, all such holders must be excluded from the number of holders of record. This adds a degree of difficulty to determining the threshold number. Depending on the quality of the records received pursuant to a request or subpoena, it may be challenging and resource intensive to determine the status of certain shareholders or the origin of the shares they hold in order to determine if the issuer is over the holders of record threshold set forth in Section 12(g) of the Exchange Act.

2. What are the forms in which securities of such issuer are held and are any such forms of holding used primarily to circumvent the registration provisions of Section 12(g) or the reporting provisions of Section 15(d) of the Exchange Act?

The Division of Enforcement would likely use its authority to request or subpoena documents, as well as to request interviews or sworn investigative testimony from witnesses who might have knowledge related to the creation and purposes of the form of holding the securities of the company at issue and to investigate if the parties involved have any incentive to cause the issuer to avoid registration.

[97] See supra Part IV.A.

3. Does the issuer know or have reason to know that the form of holding is used primarily to circumvent the registration provisions of Section 12(g) or the reporting provisions of Section 15(d) of the Exchange Act?

The staff of the Division of Enforcement have the ability to request or subpoena documents and request interviews or subpoena sworn investigative testimony from witnesses who might have knowledge of what the issuer knew or had reason to know about the uses and form of securities holdings.

B. Application

Despite a robust array of investigative tools at its disposal, the Division of Enforcement would likely face several challenges in pursuing a potential violation based on Rule 12g5-1(b)(3), as described below. The staff nevertheless believes that as currently formulated, the relevant statutes, rules, and procedures provide the Division of Enforcement with adequate tools to investigate each of these elements and to bring a case for violations of Section 12(g) based on Rule 12g5-1(b)(3), as appropriate.

First, by definition, this rule applies to companies that do not currently file periodic reports with the Commission and do not have a reporting requirement because of an issuance of securities pursuant to an effective registration statement. Therefore, there is no direct mechanism by which Commission staff could determine which companies are approaching their statutory threshold or have securities being held in forms that might be used primarily to circumvent Section 12(g). Companies that are not registered with the Commission may avail themselves of a transfer agent, but are not required to. Additionally, while some transfer agents are regulated by the Commission, many are not. Therefore, using transfer agents as a direct mechanism to determine whether companies are above the threshold would have limited effectiveness.

Thus, the Division of Enforcement may look to its Office of Market Intelligence and its Tips, Complaints, and Referrals system for information concerning potential violations of Section 12(g). In addition, a whistleblower with knowledge of a potential violation is able to submit a complaint to the Division of Enforcement's Office of the Whistleblower. The Division of Enforcement also receives referrals from the Office of Compliance, Inspections, and Examinations concerning possible violations of the securities laws that are discovered during examinations and inspections of registered entities.

Second, even if the staff were to be alerted to a situation in which a form of holding might have been, or may be being, used primarily to circumvent the requirements of 12(g), the elements of a Rule 12g5-1(b)(3) violation pose investigational and evidentiary challenges. As discussed above, Rule 12g5-1(b)(3) turns on two issues: first, that the form of holdings be "primarily" used to circumvent the statutory thresholds; and second, that the issuer "knows or has reason to know" how the form of holding is used. Determining intent is typically more difficult than measuring a quantitative standard. For example, an issuer may have its securities held by a special purpose vehicle that holds only the issuer's securities for the benefit of many investors. Determining whether the special purpose vehicle triggers Rule 12g5-1(b)(3) and therefore should count as one shareholder or many depends, in part, on the vehicle's "primary" purpose, which can raise a difficult question of fact.

In a similar vein, the Division of Enforcement staff would need to evaluate whether the issuer had actual or constructive knowledge that the form of holding was being used primarily to circumvent the issuer's Section 12(g) obligation. As discussed above, such an evaluation could turn, in part, on how involved the issuer was in the creation or administration of the form of holding. The less involved an issuer was in creating or administering the special purpose vehicle,

the harder it would be for Enforcement staff to establish the requisite knowledge. Conversely, if the issuer was deeply involved, it could be much easier for the staff to establish, and in turn, harder for the issuer to deny, actual or constructive knowledge. Thus, whether the issuer "knows or has reason to know" that the special purpose vehicle is a form of holding being used primarily to circumvent the registration requirements of 12(g), can also present a difficult factual question that turns, in part, on the level of the issuer's involvement.

Finally, with the passage of the JOBS Act, and the new higher thresholds for holders of record, the empirical data from the Division of Risk, Strategy and Financial Innovation indicates that a significantly reduced number of current registrants would trigger the new 12(g) record holder requirement. However, the amendments to Section 12(g) provided by the JOBS Act also include a separate threshold for unaccredited investors (less than 500 holders of record that are not accredited investors) which was not a distinction in the record holder threshold that could be segregated by the Division of Risk, Strategy and Financial Innovation. This could prove to be a new area for possible circumvention efforts using special purpose vehicles if private companies find that their unaccredited shareholders of record begin to reach the 500 holder threshold. However, as noted above, it may be difficult for the Enforcement staff to know that such circumvention is occurring other than through a tip, complaint or referral.

VI. Conclusion

The current enforcement tools available to the Commission are adequate to enforce the anti-evasion provision of Rule 12g5-1. While difficult to detect at the outset, once the staff is alerted to a potential circumvention of Section 12(g), the current authority to investigate potential violations of the securities laws provides the staff with a wide variety of tools to gather facts. The increase in the Section 12(g) threshold from 500 holders of record to 2000 included in the JOBS

Act may reduce the motivation of issuers and others to engage in circumvention efforts, although it is possible that the requirement to register if the number of non-accredited holders of record exceeds 500 may mitigate that effect. Since those changes were just recently enacted, time will need to pass before the impact, including the impact on possible circumvention efforts, can be assessed. We therefore have no particular legislative recommendations regarding enforcement tools relating to Rule 12g5-1(b)(3) at this time.