Allowing ALL Shareholders to Benefit from JOBS Act Legislation

Shareholders in Private Companies Wait Twice as Long for a Traditional Liquidity Event

With the enactment of the Jumpstart Our Business Startups (JOBS) Act of 2012, private companies have the ability to defer an IPO and SEC reporting, and remain private longer than at any time in the past. The result, however, is that shareholders and employees of these companies face a much longer wait time for public liquidity, a fact that negatively impacts private company capital formation and job creation.

Why Should Private Company Shareholders Be Able to Sell Stocks?

Facilitating shareholder liquidity is critical to the overall success of private companies. Private companies, like thousands of community banks and most fast growing startups, find it much easier to raise primary capital when prospective investors understand that some degree of liquidity will be available to them, particularly in the case of private companies that wish to remain private and defer their IPOs. In addition, private companies are better able to attract and retain talented employees when those employees are able to monetize at least part of their equity compensation prior to an IPO. Making equity compensation more attractive to prospective employees will facilitate job creation and startup growth.

Challenges for Employee Shareholders - Exercising Stock Options Can Be Tricky and Costly

Startup companies rely heavily on stock-based compensation in lieu of cash compensation to conserve capital. Most employees are granted options representing common shares that vest over several years. Options provide an economic incentive that allows employees to realize the financial upside of contributing to a successful startup.

Exercise of employee options requires that the employee pay the option exercise price and income taxes at the time of exercise. Typical startup employees cannot fund these costs out of pocket and must structure an exercise and immediate resale of a portion of their common shares to cover these costs. The problem is that current federal law only provides a safe harbor and state securities law preemption for private company share resales where the seller is not an affiliate of the private company and can demonstrate that he has held the shares being sold for at least 12 months. These qualifications evidence a seller's compliance with the Rule 144 safe harbor promulgated under Section 4(a)(1) of the Securities Act of 1933.

Since holding vested options does not count towards the 12 month requirement for the underlying common stock, employees cannot exercise their vested options and simultaneously resell their common stock under Rule 144. Instead, they must navigate all the applicable federal and state requirements to exercise the options and sale or resale of the common shares. Engaging legal counsel to conduct the analysis on their behalf can be cost-prohibitive. As a result, a substantial amount of private company employees' options may end up not being exercised in cases where a private company delays an IPO or the employee leaves the company and, instead, expire, resulting in economic loss and income reduction.

Challenges for Founders, Officers and Other Significant Shareholders

Private company officers, directors, and shareholders who own more than 10% of the company's equity are also precluded from relying on Rule 144 because they are considered affiliates of the company. Without a Rule

144 exemption, these shareholders also need to identify both a federal and state exemption from registration for the resale transaction. The disadvantage of not providing these types of shareholders a clear path to liquidity is that it becomes more difficult for the private company to raise capital and attract and keep talented employees. For community banks, these disadvantages can also impact lending activities.

What is the Current Framework for Resales by these Shareholders?

Over the last 60 years, a legal construct referred to as "Rule 4(a)(1 ½)" has developed as a result of case law and legal analysis that provides a federal level exemption from registration for these types of transactions. The basic requirement of Rule 4(a)(1 ½) is that the transaction satisfies certain elements of both Section 4(a)(1), the non-issuer exemption, and 4(a)(2), the issuer exemption, such as that there is no public offering and that all buyers are accredited investors. While the SEC has never acted to codify the Rule 4(a)(1 ½) construct, it has acknowledged the validity of the exemptive theory in an interpretive release and in several no-action letters.

The most significant disadvantage of the lack of a codified federal safe harbor for these transactions is that each transaction must also satisfy the blue sky laws of the state of residence of every potential accredited investor buyer. State regulations relating to these transactions are generally inconsistent, which makes it very difficult to establish a uniform liquidity program across state lines. In addition, almost every state other than New York prohibits broker dealers from reaching out to their existing accredited investor clients to identify potential interest in these transactions. This prohibition is inconsistent with SEC and FINRA rules, which allow broker dealers to discuss opportunities with clients if there is a pre-existing relationship.

A Targeted Solution to These Shareholder Liquidity Issues

The 2013 SEC Government-Business Forum on Small Business Capital Formation recommended a solution: amend the Securities Act of 1933 to include Section 4(a)(7) to provide a new federal safe harbor that merely codifies the existing Rule 4(a)(1 ½) legal framework applicable to sales by shareholders who cannot rely on Rule 144. Rule 4(a)(1 ½) transactions are already subject to the federal and state anti-fraud provisions, so sellers are subject to fines and sanctions where a securities violation occurs. These transactions are also considered "run of the mill" by the legal community and many well-respected law firms issue legal opinions with respect to these resale transactions every day.

The resale of private company stock by shareholders generates significant income and capital gains tax revenues at the state level. Codifying a clear and workable legal framework for these transactions should result in increased tax revenue, in addition to facilitating private company capital formation and job creation.