

SEC Amends Rule 701 and Solicits Public Comments on Further Changes to Rule 701 and Form S-8 in a Concept Release

July 2018

Authors: Colin Diamond, Dov M. Gottlieb, Michelle Rutta, Irina Yevmenenko, Danielle Herrick

On July 18, 2018, the Securities and Exchange Commission (“SEC”) issued final rules to amend Rule 701(e) of the Securities Act of 1933 (the “Securities Act”) to raise the threshold value that triggers the requirement to deliver additional disclosure to investors when an unlisted issuer, which may include private domestic companies and foreign private issuers (“FPIs”) listed in home jurisdictions, issues securities pursuant to a compensatory arrangement in reliance on an exemption from the registration requirements under Rule 701. In addition, the SEC issued a concept release soliciting comments on possible ways to modernize its rules related to compensatory securities offerings in light of various recent developments, such as proliferation of the so-called “gig economy”.

Rule 701(e) Amendments

Rule 701 provides an exemption from registration for securities issued by non-reporting companies for compensatory purposes to certain eligible recipients, including company employees, officers, directors, partners, trustees, consultants and advisors.¹ Currently, companies relying on the Rule 701 exemption may avail themselves of limited disclosure requirements to eligible recipients until the aggregate sales price of securities

¹ Under Rule 701, non-reporting companies can issue securities to employees and other covered persons (e.g., directors and certain consultants and advisers) without SEC registration so long as the securities are granted or issued pursuant to a written compensatory benefit plan (including an employment agreement). In order to rely on this exemption, the aggregate sales price or amount of securities sold under Rule 701 must not exceed the greatest of the following: \$1 million; 15 percent of the total assets of the issuer, measured as of the date of the issuer’s most recent balance sheet; or 15 percent of the outstanding amount of the class of securities being offered and sold in reliance on Rule 701, measured as of the date of the issuer’s most recent balance sheet.

Each of the limitations is calculated with respect to the aggregate sales price or amount of securities sold in reliance upon Rule 701 in any consecutive 12-month period. The 12-month period may be measured either on a fixed annual basis or on a rolling 12-month basis, provided that the measurement period is applied consistently and not changed.

issued under the exemption in the prior 12-month period reaches \$5 million. This is typically accomplished by providing the eligible recipients with a copy of the equity plan and related award agreements prior to, or at the time of, an equity grant being made. If a company's issuances exceed the \$5 million threshold, the company is required to provide more robust disclosures, including a summary of the compensatory plan or arrangement, financial statements dated not more than 180 days before the sale and a list of risk factors associated with the securities.² For any subsequent offers or sales, such delivery must be made a reasonable time before the date of sale of stock, the date of grant of restricted stock units ("RSUs") or the date of exercise of stock options. If a company fails to do so, the Rule 701 exemption becomes unavailable for prior offers and sales during the relevant 12-month period, even those issued before the company exceeded the disclosure threshold. Non-reporting FPIs are required to provide the same disclosure as non-reporting domestic issuers if sales under Rule 701 exceed \$5 million within any 12-month period. This reporting obligation can be particularly onerous for FPIs if the issuer's financial statements are not otherwise prepared in accordance with US GAAP, as Rule 701 requires that the financials provided must be reconciled to US GAAP unless they are prepared in accordance with IFRS.

The amendments to Rule 701(e)³ increase the additional disclosure threshold from \$5 million to \$10 million; Rule 701(e) will otherwise continue to operate in the same manner as it currently does. This revision was mandated by the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Act"), which was signed into law in May 2018. The Act also requires that the threshold amount be indexed for inflation every five years.

The revision to Rule 701(e) became effective upon its publication in the Federal Register on July 24, 2018. Companies that have commenced an offering in the current 12-month period will be able to apply the new \$10 million disclosure threshold immediately upon effectiveness of the amendment.

Modernization of Rule 701 and Form S-8: Concept Release

The SEC also published a concept release⁴ soliciting comments on possible ways to modernize rules related to compensatory securities offerings and sales in light of the significant evolution in both the types of equity compensation and the composition of the workforce, including the types of contractual relationships between companies and individuals involving alternative work arrangements, since the rules were last substantively amended in 1999, with the central question being the meaning of the term "employee" in the new "gig economy". Specifically, the SEC is soliciting comment on possible ways to update the requirements of Rule 701 and Securities Act Form S-8.⁵ The concept release poses a total of 56 questions, mostly focused on Rule 701, concerning, among other things:

- Expanding Rule 701 to allow use by public companies.
- Revising the disclosure content and timing requirements of Rule 701(e).
- Modifying or eliminating annual sales caps under Rule 701(e). In this context, the concept release notes that the current caps may be of particular concern to smaller companies that rely on equity compensation to attract talent.
- Addressing RSUs, which have become increasingly common since Rule 701 was last substantively amended. Unlike options or other derivative securities (for which disclosure under Rule 701 must be delivered a reasonable time before exercise or conversion), RSUs settle without the recipient making an investment

² Companies may deliver the required disclosures in hard copy or electronically (e.g., by email or by access to a website). Electronic delivery methods should be consistent with the SEC's guidance, including the recent clarification regarding the use of standard electronic safeguards, such as user-specific login requirements. See Compliance and Disclosure Interpretation 271.25.

³ The amendments to Rule 701(e) are available [here](#).

⁴ The concept release is available [here](#).

⁵ Form S-8 is a short-form registration statement available for use by reporting companies that are current in their filings for the past 12 months (or shorter period since becoming a reporting company). Form S-8 is available for the registration of securities to be issued under any employee benefit plan to a company's employees and certain other service providers.

decision, meaning that the investment likely takes place at the date of grant. Consequently, the issuer's obligation to provide Rule 701(e) disclosure would be a reasonable period of time before the date the RSU is granted, which may result in a delivery obligation at a time when employment agreements are being negotiated. The concept release seeks comments regarding whether Rule 701 should be amended to specifically address the timing of Rule 701(e) disclosure for RSUs or similar instruments, and whether timing requirements should be different for new hires. The concept release also seeks to clarify how RSUs should be valued for Rule 701 purposes.

- Increasing the availability of Rule 701 and/or Form S-8 for securities issued to non-traditional workers, including short-term, part-time or freelance workers (referred to as "gig economy" relationships) (since individuals participating in these arrangements do not enter into traditional employment relationships, they may not be deemed eligible participants under Rule 701 or Form S-8).
- Simplifying requirements for Form S-8, including whether a specific amount of shares should be required to be disclosed, how additional shares may be added to Form S-8, allowing issuers to register on a single form offers and sales pursuant to all of their employee benefit plans, or potentially eliminating Form S-8 altogether, allowing public companies to rely on Rule 701, and providing resale of restricted or control shares issued under employee benefits plans via Form S-3.
- Implementing a "pay-as-you-go" fee structure for Form S-8 registration fees in light of the current requirement to register a specific number of shares on a Form S-8.

Comments are due by September 24, 2018.

Practical Considerations

Although the amendments to Rule 701 are intended to encourage private companies to use equity compensation by reducing the expense and concerns of the enhanced disclosure requirements, given the modest increase in the enhanced disclosure threshold, the impact of this rule change may not be very significant. Nevertheless, the recent amendments and the concept release underscore the SEC's commitment to adopting a regulatory framework that is both flexible and responsive to the modern economy and the evolving nature of the capital markets.

Companies that offer securities under compensatory arrangements in reliance on Rule 701 may want to review whether it would be beneficial for them to increase the size of their programs, while maintaining a level at which they would not need to incur the expenses of additional disclosures. In addition, despite the added cushion, companies should continue to carefully track the aggregate value of securities granted (or expected to be granted) in any consecutive 12-month period to confirm compliance with Rule 701's offering limitations and should remain mindful that failure to comply with the enhanced disclosure requirements can lead to SEC enforcement action and potential penalties. For example, the SEC recently fined Credit Karma, a financial technology company, due to the company's failure to provide adequate disclosures once its stock option issuances exceeded the disclosure threshold amount.

White & Case LLP
1221 Avenue of the Americas
New York, New York 10020-1095
United States

T +1 212 819 8200

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