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SEC Amends Rule 701(e) and Issues Concept Release Regarding Rule 701 and Form S-8

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On July 18, the SEC voted unanimously to adopt an **amendment to Rule 701** – the exemption from registration for securities issued by non-reporting companies under compensatory arrangements – to raise the threshold in Section (e) that triggers the requirement for delivery of additional disclosure to investors from $5 million to $10 million. The amendment to Rule 701(e) became effective on July 23, 2018, thus allowing companies that have commenced an offering in the current 12-month period to "be able to apply the new $10 million disclosure threshold immediately upon effectiveness of the amendment."

The amendment was mandated by the **Economic Growth, Regulatory Relief, and Consumer Protection Act**, which was signed into law in May. The specificity and deadline imposed by that mandate left little room for debate or even discretion, making adoption of the final amendment by the commissioners into a relatively perfunctory exercise. However, the commissioners did take the opportunity, through the issuance of a new **concept release**, to propose what amounts to a reexamination of the entire regulatory scheme for offers and sales of securities for compensatory purposes. In particular, the release invites public comment on how to modernize Rule 701 and Form S-8, as **Chair Jay Clayton observed**, in light of "developments and innovations in labor markets and compensation practices."

Amendment to Rule 701(e)

Rule 701 allows non-reporting companies to sell securities under compensatory benefit plans or written agreements without the requirement to register the offer and sale of the shares with the SEC. The so-called "soft cap" of Rule 701(e) requires that additional disclosures be provided to investors if a specified level of sales under the rule is exceeded. As **Commissioner Kara Stein** explained, the underlying theory for the cap is that the larger the offering, in the absence of accompanying investor protections, the greater the possibility of harm.

Under the Economic Growth, Regulatory Relief, and Consumer Protection Act, the SEC was required, not later than 60 days after enactment of that act, to revise Section (e) of Rule 701 to raise the threshold that triggers the requirement for delivery of additional disclosure from $5 million to $10 million. The act also requires that the amount be indexed for inflation every five years to reflect the change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics, rounding to the nearest $1,000,000.

As amended, under Rule 701(e), if the aggregate sales price or amount of securities sold by the company under Rule 701 during any consecutive 12-month period exceeds $10 million, the company is required to provide (in addition to a copy of the plan or contract, which is required in all cases) a summary of the plan's material terms together with a description of risk factors and financial statements for the company, as would be required in a Regulation A offering on Form 1-A. The company "must deliver those additional disclosures a reasonable period of time before the date of sale to all investors in the 12-month period." As amended, Rule 701(e) will otherwise continue to operate in the same manner as it did prior to the amendment.

Concept release

While companies will be pleased to have more latitude under the new Rule 701(e) threshold, significant issues remain for companies attempting to navigate the requirements of the rule. The concept release attempts to open for comment some of these issues.

As noted in the new concept release, the SEC has consistently recognized that securities transactions for capital-raising purposes are different in nature from securities transactions for compensatory purposes in that, in the latter case, the employee has a different relationship with the employer-issuer and the employee's investment decision is "of a different character." In addition, in contrast to capital-raising issuances, equity compensation is often used "to align the incentives of employees with the success of the enterprise, facilitate recruitment and retention, and preserve cash for the company's operation." Accordingly, the SEC has long had a separate regulatory regime for compensatory transactions. However, in the many years since Rule 701 and Form S-8 were last amended, "forms of equity compensation have continued to evolve, and new types of contractual relationships between companies and the individuals who work for them have emerged." In light of these changes, the SEC viewed it as an appropriate moment to revisit these regulations.

Rule 701

The "gig" economy. By far, the most interesting question raised in the concept release relates to how, or if, the rule should be modified to reflect changes in the society at large in the relationships between workers and companies in the almost 20 years since the rule was last amended. In particular, the release asks us to consider whether the conditions for eligibility should be revised in light of the "gig" economy and evolving worker-company relationships. Should the special accommodation provided by Rule 701 for the issuance of equity for compensatory purposes to employees, directors and consultants be extended to non-traditional workers who may be providing services under alternative work arrangements or contractual relationships, sometimes with multiple companies, that may be short term or freelance in nature? If so, what parameters should apply? What types of activities by the worker or control by the company and what level of "dependence" – by the worker on the company and vice versa – should be required to establish a "sufficient nexus between the individual and the issuer to justify application of the exemption for compensatory transactions"? What test would best position a company to determine on its own whether it could rely on the rule? Could the definitions of "consultant" or "*de facto* employee" (a non-employee providing services traditionally performed by an employee, with compensation paid for those services being the primary source of the person's earned income) be appropriately applied or extended to these workers? Should the tax definition of "employee" or other regulatory definition be imported into Rule 701?

The concept release also raises issues beyond eligibility. Should there be a separate ceiling for securities issued to "gig" workers? Should all types of companies be treated the same, regardless of the worker relationship? Do companies even want to issue equity as compensation to motivate workers under these alternative work arrangements? Would an expansion of the rule lead to more "gig" workers? What effect would a liberalization of the rule have on incentives to companies to "go public and stay public," a rite of passage the SEC has recently championed, or on incentives to remain private?

There are many more questions identified in the concept release. The SEC advises that its evaluation of any potential changes will be conducted through the lens of "retaining the compensatory purpose of Rule 701 and avoiding potential abuse of the rule for capital-raising purposes, consistent with the Commission's investor protection mandate."

Rule 701(e) disclosure requirements. As noted above, if the aggregate sales price or amount of securities sold during a 12-month period exceeds $10 million, the company must deliver additional disclosures to investors a reasonable period of time before the date of sale to all investors in the 12-month period. While the concept may sound simple enough on its face, in practice, it has involved enormous complications and ambiguities. The concept release attempts to take some of them on. For example, the rule, in effect, requires companies "to anticipate, up to 12 months before exceeding the $[10] million threshold, the possibility that they may do so, and to supply plan participants with the additional disclosures for that period." Recognizing the inherent challenge in

satisfying that requirement, the release asks whether the required disclosure should apply instead to the period *after* the threshold is exceeded and for which additional disclosure was not provided. In addition, should there at least be a grace period to provide the required disclosure? Should there be a regulatory alternative to provide all of the information, other than financial statements, to all investors? Should there be changes to the consequences of failure to comply with the disclosure or other requirements?

Providing current financial statements as of a date no more than 180 days before the date of sale also presents issues – the effect is to require that companies always have quarterly financials available. Should valuation information be allowed as a substitute? The release also asks whether the type of information provided should depend on the recipient and whether it could be updated less frequently. Does the SEC need to change, or at least clarify, the timing and medium for delivery of the disclosure?

Options and RSUs. For derivative securities such as options, the obligation to deliver Rule 701(e) disclosure depends on whether the option was granted during a 12-month period when the disclosure threshold was exceeded. In that event, the additional disclosure must be delivered a reasonable period of time before the date of exercise or conversion. However, RSUs, which have become more prevalent in recent years, are not expressly addressed in Rule 701. What's more, because RSUs settle by their terms without an event of exercise, according to the release, "the relevant investment decision for the RSU, if there is one, likely takes place at the date of grant." Accordingly, because the date of grant is considered the date of sale, the company is then required to provide Rule 701(e) disclosure a reasonable period of time before the date of grant. That could present a challenge regarding confidentiality, the release recognizes, when the potential recipient has not yet joined the company. The release asks whether the timing of these events should be revisited.

Rule 701(d) exemptive conditions. In this section, the SEC asks whether the Rule 701 "hard cap" on 12-month sales – the greater of 15% of total assets or 15% of the total class of outstanding securities, subject to a $1 million annual cap if greater – is "unduly restrictive"? Should the annual ceiling be raised or eliminated altogether?

Form S-8

Form S-8 may be used only to register sales of securities under any employee benefit plan or compensatory agreement to employees, directors, consultants and advisors and *de facto* employees, but may not be used for capital-raising purposes. In this context, the SEC is inviting input on whether the scope of eligible persons should be the same as under Rule 701; that is, should accommodations made under Rule 701 for "gig" economy workers be extended to Form S-8? In addition, the SEC is soliciting comment on other ways to reduce costs and further streamline the form, such as by allowing the use of a single S-8 for all plans and permitting companies to pay fees on an as-you-go basis. Moreover, the SEC inquires, should the SEC eliminate Form S-8 altogether and instead extend Rule 701 to reporting companies?

If you have any questions about this alert, please contact one of your Cooley team members or one of the attorneys identified here.

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