



SECURITIES LAW ALERT

SEC AMENDS RULE 701 TO MAKE IT LESS BURDENSOME

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Grants of securities to employees, including stock options, restricted stock and restricted stock units (RSUs), are subject to federal securities laws. Pursuant to the Securities Act of 1933, as amended (Securities Act), issuances of these securities must generally be registered with the Securities and Exchange Commission (SEC) unless an exemption from registration applies. Rule 701 of the Securities Act provides an exemption from the Securities Act registration requirements for private companies (*i.e.*, those not subject to the reporting requirements of the Securities Exchange Act of 1934, as amended) that offer and sell securities under written compensatory benefit plans.

On July 18, 2018, the SEC issued final rules amending Rule 701. The amended version of Rule 701 became effective on July 24, 2018, when it was published in the Federal Register. While this Alert focuses on the Rule 701 securities registration exemption under federal law, you should be aware that state securities laws also apply to securities offerings and, thus, applicable state securities laws should be monitored in connection with a company's grant of securities.

The SEC's recent amendment to Rule 701 raises the threshold value that triggers heightened disclosure requirements under Rule 701(e) from \$5 million to \$10 million. As such, the amendment will spare some private companies from certain regulatory burdens associated with their equity compensation programs. At the same time, the amendments may encourage the use of equity compensation programs as a means for incentivizing employees, facilitating recruitment and retention, and improving company performance.

REQUIREMENTS OF RULE 701

Rule 701 of the Securities Act provides an exemption from registration for securities issued by private companies under written compensatory benefit plans, provided that the securities are issued to certain eligible recipients, such as company employees, officers, directors, partners,

trustees, consultants and advisors. For a company to utilize the exemption found in Rule 701, the amount of securities sold by the company may not exceed, in any 12-month period, the *greater of*: (i) \$1 million; (ii) 15% of the company's total assets; or (iii) 15% of the outstanding amount of the class of securities being offered and sold in reliance on the exemption. In addition, a company that utilizes the benefits of Rule 701's exemption must (y) disclose material information about the plan, the securities and the company to satisfy the anti-fraud provisions of federal securities laws and (z) disclose certain information to eligible plan participants, pursuant to Rule 701(e).

When a company's aggregate sales price of securities issued under the Rule 701 exemption is below the amended dollar threshold in a 12-month period, the company is only required to provide a copy of the applicable compensatory benefit plan to eligible plan participants prior to, or at the time of, an equity grant being made. Pursuant to Rule 701(e), when the dollar threshold is exceeded, the company must provide a more robust set of disclosures to eligible plan participants, which includes (i) company risk factors, (ii) financial statements required by Part F/S of Form 1-A under Regulation A of the Securities Act, which must be audited for certain issuers and (iii) a summary of the plan (or, in the case of a plan subject to the Employee Retirement Income Security Act of 1974, a summary plan description). Also, for offers or sales made after the threshold is exceeded, the delivery of this information must be made a reasonable time before the date of sale of stock, the date of grant of RSUs or the date of exercise of stock options. Notably, if a company fails to satisfy the Rule 701(e) disclosure requirements, the Rule 701 exemption becomes unavailable for prior offers and sales during the relevant 12-month period. In addition to penalties imposed by the SEC, the company may also be required to offer to rescind the sale of the unregistered securities with statutory interest.

THE AMENDMENT AND PRACTICAL CONSIDERATIONS

As mentioned above, a company utilizing the Rule 701 exemption must provide plan recipients with—at a minimum—a copy of the applicable compensatory benefit plan. Under the previous version of Rule 701(e), if a company's aggregate sales price of securities issued under the exemption in the prior 12-month period reached \$5 million, then the company would be required to provide heightened disclosures to eligible plan participants. Pursuant to the recently amended version of Rule 701(e), however, the aggregate sales threshold triggering heightened disclosure requirements is now \$10 million.¹ With the exception of this change to Rule 701(e), Rule 701 will continue to operate in the same manner as it did prior to the amendment.

Even before the amended version of Rule 701(e) went into effect, compliance with Rule 701 required companies to track and anticipate aggregate sales prices and amounts of securities issued or to be issued under compensatory benefit plans. While some companies may have more breathing room separating current issuances and sales from the Rule 701(e) aggregate sales threshold, it is still important for companies relying on the Rule 701 exemption to monitor the aggregate sales price of securities issued and sold under Rule 701. In addition, companies relying on Rule 701 should stay aware of applicable state securities laws, which typically (but not always) track Rule 701.

Failure to adequately track this kind of information should not be expected to go unnoticed by the SEC. Rather, the SEC monitors this activity and has been known to bring actions against companies that violate Rule 701(e). In 2005, for instance, Google and its general counsel agreed

¹ The amendment provides that the threshold shall be indexed for inflation every five years.

to a cease-and-desist order pursuant to an offer of settlement with the SEC due to Google's failure to provide additional disclosures to employees despite granting securities to employees in amounts well over the then-\$5 million threshold.²

FURTHER EFFORTS TO MODERNIZE RULE 701

In conjunction with the Rule 701 amendment, the SEC also published a Concept Release soliciting public comments on possible ways to modernize rules related to compensatory securities offerings and sales. Comments are due on or before September 24, 2018, and more information regarding the Concept Release can be found at <https://www.sec.gov/rules/concept/2018/33-10521.pdf>.

CONCLUSION

Private companies taking advantage of the benefits of Rule 701 should consider the implications of the SEC's recent amendment to Rule 701(e). Among other things, the amended version of Rule 701(e) may (i) encourage certain private companies to expand their use of compensatory benefit plans and/or (ii) relieve such companies from the heightened disclosure requirements previously imposed by Rule 701(e). In any event, private companies that utilize the benefits of Rule 701's registration exemption should keep a close eye on the aggregate dollar value of securities issued and sold in any 12-month period.

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² *In the Matter of Google, Inc. and David C. Drummond*, Admin Proceeding File No. 3-11795, 2005 WL 82435 (Jan. 13, 2005).