

Rule 701 – A Time for Change?

IN SHORT

Rule 701 Prior to Amendment: Reliance on Securities Act Rule 701, a securities registration exemption for non-reporting issuers with respect to equity awards granted pursuant to a written compensatory plan, required special financial disclosure for offers over \$5 million, among numerous other requirements.

Rule 701 After Amendment: Special financial disclosure is now required only for offers over \$10 million.

Next Steps: The U.S. Securities and Exchange Commission ("SEC") is seeking public comment about Rule 701 requirements as well as the requirements for the Form S-8 registration statement, which is the way most reporting issuers register the issuance of shares under compensatory plans.

Effective July 23, 2018, the SEC amended Rule 701 of the Securities Act of 1933 to make it easier for private issuers to grant equity awards to their employees. Specifically, such issuers are required to distribute certain financial and corporate information to grantees only if the aggregate sales price or amount of securities sold during any 12-month period exceeds \$10 million (as opposed to the prior threshold of \$5 million). In addition, in SEC Release No. 33-10521 (*Concept Release on Compensatory Securities Offerings and Sales*), the SEC announced that it was seeking comment about various requirements under Rule 701 in light of the changing corporate and equity compensation landscape since the rule's initial adoption 20 years ago.



Rule 701's disclosure requirement has made it difficult, particularly for large private issuers, to rely on it when making equity awards once the \$5 million threshold is exceeded because preparing the disclosure is costly, both in time and expense.



Since 1998, Rule 701 has provided an exemption from securities registration requirements. That exemption permits companies to issue stock-based compensatory awards without registering the underlying securities if certain requirements are met, including a requirement that the amount of securities that may be sold in reliance on the exemption during any consecutive 12-month period must not exceed the greatest of:

- \$1 million;
- 15 percent of the total assets of the issuer (measured at the issuer's most recent balance sheet date); or
- 15 percent of the outstanding amount of the class of securities being sold in reliance on the rule (measured at the issuer's most recent balance sheet date).

Rule 701 also mandated that, if the aggregate sales price or amount of securities sold during the 12-month period exceeds \$5 million, then the issuer is required to deliver the following documents to investors within a reasonable period of time before the sale (or exercise, in the case of stock options):

- A copy of a summary of the plan's material terms (if the plan is not subject to ERISA) or a summary plan description (if the plan is subject to ERISA);
- Information about the risks associated with investment in the securities sold under the plan; and
- Specified financial statements, which are dated no later than 180 days before the sale of the securities being offered.

This disclosure requirement has made it difficult, particularly for large private issuers, to rely on Rule 701 when making equity awards once the \$5 million threshold is exceeded because preparing the disclosure is costly, both in time and expense. As a result, some issuers have limited their equity awards to high-level employees in order to remain under the \$5 million threshold or have had to rely on other securities registration exemptions, such as Regulation D, which has its own challenging requirements. Preparation

of this disclosure has been particularly problematic for non-U.S. issuers, especially when local financial statements are prepared in accordance with non-U.S. requirements that may not match U.S. accounting requirements.

In light of the difficulties inherent in producing such additional disclosure, the SEC amended Rule 701 so that the delivery of the additional documentation will be required only if the aggregate sales price or amount of securities sold during the 12-month period exceeds \$10 million.

Although the SEC did not approve any additional amendments to the Rule 701 exemption, the SEC is seeking public comment on ways to update the rule to better match employer needs in the current corporate and employment environment. The SEC is asking for thoughts on matters such as the types of individuals who should be eligible to receive awards under an equity plan that relies on the Rule 701 exemption, the types of disclosure that should be provided, the frequency of providing such disclosure, and the penalties for a failure to provide proper disclosure.

Due to the fact that Rule 701 and the Form S-8 registration statement are linked in terms of the reasoning on which they are both based, the SEC is also taking the opportunity to request public comment on Form S-8, which is how most publicly traded companies register shares offered under equity incentive plans. For example, the SEC is soliciting comment on the challenges that Form S-8 registration presents and whether Form S-8 registration should be eliminated and reliance on Rule 701 extended to public companies.

The SEC is accepting comments until September 24, 2018. Release 33-10521, accessible [here](#), lists the specific questions for which the SEC is seeking comment and provides additional information regarding the submission of any comments.

Conclusion

The latest amendment to Rule 701 is certainly good news to larger private issuers, both in the United States and abroad. Further, the fact that the SEC is seeking comment on both Rule 701 and Form S-8 may signal changes in the near future, which could ease the exemption and/or registration processes even further.

TWO KEY TAKEAWAYS

1. More non-reporting issuers, especially those outside of the United States, should now be able to rely on Rule 701 without having to provide special financial disclosure (or reduce award amounts or grantees to avoid the special financial disclosure).
2. Further changes to Rule 701 and/or changes to Form S-8 requirements that may result from additional SEC review could result in a more simplified exemption and/or registration process.



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