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SEC Proposes Amendments to Rule 701 and Form S-8

The SEC has proposed amendments to modernize the securities law framework for equity compensation offerings to employees and other service providers (available here). The amendments are intended to reduce compliance burdens for issuers by simplifying the requirements of Rule 701 (by which non-reporting issuers may issue equity-based compensation without registration under the Securities Act) and Form S-8 (by which reporting issuers may register securities issued under equity-based compensation plans). These amendments would benefit both domestic issuers and foreign private issuers, and certain of the proposed amendments are for the specific benefit of foreign private issuers.

In a simultaneous, but separate, release, the SEC proposed amendments to Rule 701 and Form S-8 that would permit grants of equity awards to gig economy workers (or platform workers) under Rule 701 and Form S-8. For a summary of the SEC's proposal concerning gig economy workers, please see our separate Client Alert, "SEC Proposes to Permit Offerings of Equity Compensation to Gig Economy Workers."

The key proposed amendments to Rule 701 and Form S-8 include:

- expanding the eligible recipients of securities issued under Rule 701 and Form S-8 to include, subject to certain conditions:
  - consultants and advisors that are entities;
  - former employees, with respect to post-termination grants in connection with prior employment or service;
  - former employees of acquired entities, with respect to the acquiring company securities issued in exchange or substitution for the acquired entity's securities (which would be a welcome relief in the M&A context for acquiring companies that roll-over equity awards of their target companies to acquiring company stock, as this would relieve the acquiring company of the costly obligation to register these rolled-over equity awards on Form S-3); and
  - employees of any subsidiary (not just wholly-owned or majority-owned subsidiaries);
- increasing two of the three calculations for the maximum amount of securities issuable pursuant to Rule 701, so that issuers could, in any 12-month period, sell securities in an amount up to the greater of:
  - 25% of assets (up from 15%);
  - $2 million (up from $1 million); or

- 15% of the amount or class of securities offered (unchanged);

- relaxing the disclosure requirements for issuances under Rule 701 exceeding $10 million in any 12-month period, including by requiring these disclosures only for issuances in excess of the $10 million threshold, and relaxing the age of the required financial statements so that issuers need only prepare these semi-annually instead of quarterly;
- clarifying that issuers may use an automatically effective post-effective amendment to an existing Form S-8 to add plans, additional securities and additional classes of securities, instead of filing a new Form S-8; and
- clarifying that issuers may use a single Form S-8 to register an unallocated pool of securities underlying multiple incentive plans.

Rule 701 Proposed Amendments

Eligible Recipients

The proposal would expand the following categories of persons eligible to receive Rule 701 issuances (and securities registered on Form S-8):

Consultants and Advisors. Consultants and advisors that are entities that meet the following conditions (in addition to the existing requirements applicable to consultants and advisors):[1]

- substantially all of the activities of the entity involve the performance of services; and
- substantially all of the ownership interests in the entity are held directly by:
  - no more than 25 natural persons, of whom at least 50% perform such services for the issuer through the entity;
  - the estate of a natural person specified above; and
  - any natural person who acquired ownership interests in the entity by reason of the death of a natural person specified above.

[1] The current Rule 701 eligibility requirements for consultants and advisors require such persons to provide *bona fide* services that are not in connection with the offer or sale of securities in a capital transaction and do not directly or indirectly promote or maintain a market for the issuer's securities. *See* Rule 701(c)(l)(ii) and (iii).

- **Former Employees**. Former employees[2] who:
  - were employed by, or provided services to, the issuer, its parents, its subsidiaries or subsidiaries of the issuer's parent and who are issued securities after resignation, retirement or other termination as compensation for services rendered during a performance period that ended within 12 months preceding such termination; and
  - were employed by an entity that was acquired by the issuer if the securities are issued in substitution or exchange for securities that were issued to the former employees of the acquired entity on a compensatory basis while such persons were employed by or providing services to the acquired entity.[3]
- **Employees of Subsidiaries**. Under the proposal, employees of any subsidiary, not just majority-owned subsidiaries, would be eligible to receive Rule 701 compensatory securities.

Maximum Issuance Thresholds

The SEC has proposed increasing two of the three calculations for the maximum threshold amount of securities,[4] so that issuers would be permitted, in any 12-month period, to sell securities in reliance on Rule 701 in an amount up to the greater of:

- **Asset threshold** – 25% (up from 15%) of the total assets of the issuer (or of the issuer's parent if the issuer is a wholly-owned subsidiary and the securities represent obligations that the parent fully and unconditionally guarantees), measured at the issuer's most recent balance sheet date;
- **Dollar threshold** – $2 million (increased from $1 million); and

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2 For purposes of Rule 701, term "employees" would include executors, administrators and beneficiaries of the estates of deceased employees, guardians or members of a committee for incompetent former employees, or similar persons duly authorized by law to administer the estate or assets of former employees.

3 Notably, under the current instructions to Form S-8, former employees of the issuer are permitted to acquire issuer securities through intra-plan transfers among plan funds, if permitted under the terms of the plan (*e.g.*, pursuant to a 401(k) plan that permits investments of account balances in a company *stock* fund). The proposed revisions to these instructions, as drafted, would permit former employees of an acquired company to similarly invest his or her 401(k) plan balance in an acquiring issuer's company stock fund investment alternative if offered under the 401(k) plan. See the proposed revisions to Form S-8 General Instruction A.1.(a)(3)(ii).

4 The proposed increases would be a welcome change for non-reporting issuers. Even though most private companies are able to satisfy their equity compensation issuance needs via a combination of Rule 701 and other private placement exemptions, Rule 701 is a favored exemption given its shortened post-IPO holding period requirements (90 days following an IPO).

- **Outstanding amount of securities threshold** – unchanged at 15% of the outstanding amount of the class of securities being offered and sold.

In the case of completed business combination transactions, the acquiring issuer would be able to use a *pro forma* balance sheet that reflects the transaction or a balance sheet as of a date after the completion of the transaction that reflects the total assets and outstanding securities of the combined entity. In determining the amount of securities that it may offer pursuant to Rule 701 following a business combination transaction, the acquiring issuer would not be required to include the aggregate sales price and amount of securities for which the acquired entity claimed the exemption during the same 12-month period.

Disclosure Requirements

The SEC has proposed amending the disclosure requirements under Rule 701(e) applicable to transactions where the aggregate sales price or amount of securities sold during any consecutive 12-month period exceeds $10 million as follows:

- **Disclosure Requirement for Pre-Threshold Issuances**. The SEC has proposed amending Rule 701(e) so that the requirement to provide additional disclosure[5] in transactions exceeding $10 million would only apply with respect to those sales that exceed the $10 million threshold.

  Under the current rules, if compensatory sales in a 12-month period exceed the $10 million threshold, the issuer must provide the additional disclosures mandated by Rule 701(e) with respect to all issuances, including those made before the $10 million threshold is surpassed. These disclosures must be provided at the time of issuance, not retrospectively. As a result, issuers under the current rules must anticipate whether their compensatory issuances could exceed $10 million within any 12-month period and deliver appropriate disclosures, or risk losing the exemption.

- **Age of Financial Statements**. Under the proposal, financial statements would need to be made available on at least a semi-annual basis and completed within three months after the end of the second and fourth quarters. This in effect increases the permitted age of financial statements to 270 days.

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[5] Pursuant to Rule 701(e), issuers conducting compensatory offerings of securities must deliver to investors a copy of the compensatory benefit plan or contract. Additionally, for any compensatory offerings exceeding the $10 million threshold, the issuers must provide: (i) a copy of the summary plan description required by ERISA or a summary of the plan's material terms if it is not subject to ERISA; (ii) information about the risks associated with investment in the securities sold pursuant to the compensatory plan or compensation contract; (iii) certain financial statements required to be furnished under Regulation A; and (iv) for foreign private issuers only, a reconciliation to U.S. GAAP if their financial statements are not prepared in accordance with U.S. GAAP or IFRS (as issued by the International Accounting Standards Board).

Under the current rules, financial statements must be as of a date no more than 180 days before the date of sale of securities relying on the Rule 701 exemption, and be completed within three months after the quarter end. As a result, in order to be able to offer compensatory securities throughout the year on an interrupted basis, companies must prepare quarterly financial statements. As the SEC noted, this requirement has proved particularly burdensome for foreign private issuers that are normally required to provide only semi-annual and annual financial statements under their home country rules. The existing requirements under Rule 701 to provide financial statements that are current within 180 days (for grants in excess of $10 million) has required many such issuers relying on Rule 701 to impose moratoriums on exercises of options and grants of restricted stock units for periods when their financial statements became stale.

- **Financial Statement Content Requirements for Foreign Private Issuers**. The proposal would allow foreign private issuers that are eligible for the exemption from Exchange Act registration under Rule 12g3-2(b) (requiring, among other things, a home country listing) to provide financial statements prepared in accordance with home country accounting standards for purposes of Rule 701(e) disclosure without reconciliation to U.S. GAAP if financial statements prepared in accordance with U.S. GAAP or IFRS are not otherwise available. Note, however, that the SEC declined to propose modifications to the Rule 701(e) disclosure requirements to permit the use of financial statements audited under International Standards on Auditing. This then means that financial statements still would need audits prepared in accordance with U.S. generally accepted auditing standards or Public Company Accounting Oversight Board auditing standards. Foreign private issuers that are not eligible to rely on Rule 12g3-2(b) would need to provide financial statements prepared in accordance with IFRS as issued by the International Accounting Standards Board, rather than IFRS as adopted by the European Union.

- **Alternative Valuation Disclosure**. The proposal would allow issuers to provide alternative valuation information in lieu of the financial statements required under Rule 701(e) for purposes of evaluating the value of an equity award. This alternative valuation would need to include a valuation report of the securities' fair market value as determined by an independent appraisal consistent with the rules and regulations under Internal Revenue Code ("IRC") Section 409A (a "Section 409A independent valuation report") applicable to determining the fair market value of service recipient stock for stock not readily tradable on an established securities market. Additionally, in order to keep valuation information current, similar to Rule 701(e) financial statement disclosures, the Section 409A independent valuation report would need to be as of a date that is no more than six months before the sale of securities in reliance on this exemption.

  This alternative valuation method would be available for use by all issuers, other than foreign private issuers eligible for the Rule 12g3-2(b) exemption who would instead be permitted to provide alternative valuation disclosure prepared consistent with the IRC Section 409A rules and regulations applicable to

determining the fair market value of stock readily tradeable on an established securities market. To provide such valuation, the eligible foreign private issuers would simply disclose the fair market value of the stock on the most recent trading day preceding the date of sale.

- **Disclosure Requirements for Derivative Securities**. The SEC has proposed amending the date by which issuers would need to provide the required disclosure for any derivative securities that do not involve a decision by the recipient to exercise or convert. For derivative securities that involve a decision to exercise or convert (*e.g.*, a stock option), an issuer under the current rules must deliver disclosure a reasonable period of time prior to the date of exercise of conversion. Under the proposed rules, if the derivative securities do not involve a decision by the security holder to exercise or convert (*e.g.*, restricted stock units (RSUs)), then the issuer would be required to deliver disclosure a reasonable period of time before the date of grant. In the case of issuances in connection with the hire of new employees, this would be satisfied if the disclosure is provided no later than 14 calendar days after the date the new employee begins employment.

- **Disclosure Requirements Following Business Combination Transactions**. The proposal would clarify the application of the Rule 701 exemption and its disclosure delivery obligations to acquired entity derivative securities that the acquiring issuer assumes in a business combination transaction. In business combination transactions, where outstanding derivative securities issued by the acquired entity in compensatory transactions are not accelerated and are instead assumed by the acquiring issuer, the exercise or conversion of those derivative securities into shares of the acquiring issuer would be exempt from registration as long as (i) the acquired entity complied with Rule 701 at the time it first granted such derivative securities and (ii) the acquiring issuer provided information meeting the requirements of Rule 701(e) consistent with the timing requirements of Rule 701(e)(6).

  Once the business combination transaction is completed, for purposes of determining whether the amount of securities the acquiring issuer sold during any consecutive 12-month period exceeds $10 million, the acquiring issuer would only be required to include those securities it sold in reliance on Rule 701 during any consecutive 12-month period and would not be required to include any securities sold by the acquired entity pursuant to Rule 701 during the same 12-month period.

Proposed Revisions to Form S-8

Use of Automatic Post-Effective Amendment to Add Plans, Additional Securities or Classes of Securities

The proposed revisions would clarify that issuers may file an automatically effective post-effective amendment to a previously filed Form S-8 to add a new employee benefit plan where that plan does not require the authorization and registration of additional securities for offer and sale (*e.g.*, replacing an existing plan with a new one that does not authorize additional securities for issuance). This is only

intended to add clarity for those issuers who previously believed that a new Form S-8 was required for each new plan.

The proposal would also amend Rule 413 to permit issuers to add securities (of same class or an additional class) to an existing Form S-8 by filing an automatically effective post-effective amendment.

Use of a Single Form S-8 to Register an Unallocated Pool of Securities Underlying Multiple Incentive Plans

The proposals would clarify that issuers may use a single Form S-8 for multiple incentive plans, without needing to allocate registered securities among the plans. The registration statement would be required to list the types of securities and identify the plans (by full title). Issuers would need to continue to prepare and deliver a plan-specific prospectus to offerees in accordance with current requirements.

Fee Calculation and Payments for Securities Offered Pursuant to Defined Contribution Plans

The proposals would amend Rule 457 to permit registration of securities offered pursuant to defined contribution plans to be based on the aggregate offering price of all securities registered. They also would introduce a new fee payment method, pursuant to which issuers could pay the fee for all sales made during any given fiscal year no later than 90 days after the issuer's fiscal year end.

Eligible Recipients - Amendments to Conform to Proposed Rule 701 Changes

As discussed above with respect to Rule 701, the proposals include conforming amendments to expand the categories of persons eligible to receive securities issued under Form S-8 to include former employees (with respect to post-termination grants), former employees of acquired businesses (with respect to acquiring company securities issued in exchange or substitution for the acquired entity securities)[6] and certain consultants and advisors that are entities.

IRS Determination Requirements

To reflect the IRS's changed practice regarding the review of plan amendments, the SEC has proposed (i) revising Item 8(b) of Form S-8 to eliminate the requirement that issuers submit plan amendments to the IRS and (ii) revising Item 601(b)(5)(iii) of Regulation S-K to eliminate the requirement to file a copy of the IRS determination letter regarding the plan amendment.

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[6] See footnote 3 above, regarding the impact of the proposed revisions on the ability of former employees of acquired businesses to invest in an acquiring company's securities through intra-plan transfers (*e.g.*, in a 401(k) plan company stock fund).

Instead, under the proposed amendments, Item 8(b) of Form S-8 would be revised to permit issuers to provide an undertaking that they will maintain the plan's compliance with ERISA and make all changes required to maintain such compliance in a timely matter. If issuers do not provide this undertaking, then Item 601(b)(5)(iii) of Regulation S-K would continue to apply, and require issuers to file a legal opinion confirming compliance of the amended provisions of the plan with ERISA requirements.

In addition, the proposed amendments would eliminate the requirements to file a determination letter or opinion in connection with third-party pre-approved plans that have been approved by the IRS if the issuer files as an exhibit the IRS opinion letter issued to the pre-approved plan's provider.

Tax Effects of Plan Participation

The proposed amendments would eliminate the need for issuers to describe the tax effects of the plan on the issuer. Issuers would still need to disclose the tax consequences for employees, and to state whether the plan is qualified under IRC Section 401(a).

Employee Stock Purchase Plans

While the SEC did not propose any amendments, it did solicit comments regarding whether to extend Rule 701 to offers to participate in an employee stock purchase plan and whether to expand the ambit of Form S-8 to cover sales pursuant to the ESPP after an IPO.

Comment Period

The SEC has requested comments on the proposal within 60 days of the date of its publication in the *Federal Register*.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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