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SEC Eases Disclosure Threshold Under Rule 701

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page of this document or call your regular Skadden contact.

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Four Times Square
New York, NY 10036
212.735.3000

On July 18, 2018, the Securities and Exchange Commission (SEC) amended Rule 701(e) of the Securities Act of 1933 (Securities Act), as mandated by the Economic Growth, Regulatory Relief, and Consumer Protection Act. The amendment revises Rule 701(e) to increase from \$5 million to \$10 million the aggregate sales price or amount of securities sold during any consecutive 12-month period in excess of which an issuer is required to deliver to employees (and other covered persons) certain disclosures, including financial statements. Issuers that have commenced an offering in a current 12-month period will be able to apply the new \$10 million disclosure threshold immediately upon effectiveness of the amendment. The final rule amendment will become effective upon publication in the Federal Register, which is expected shortly.

Concurrent with the adoption of the final rule amendment, the SEC issued a [concept release](#) requesting public comment on various other aspects relating to Rule 701 and Form S-8 generally. We will analyze separately the concept release in a forthcoming client memorandum.

SEC Registration and Existing Rule 701

The Securities Act requires that any offer or sale of securities (including equity-based compensation such as stock options, restricted stock units and other equity compensation awards) be registered with the SEC unless either the security or the transaction is exempt. Rule 701 is the most frequent exemption used by private companies to make compensatory equity awards to their employees without registering the offering, as it allows private companies to offer and sell equity-based compensation without the burdens and expenses of SEC registration.

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, which would include an employment agreement. In order to rely on the exemption provided by Rule 701, 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 above three 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.

Before securities are issued in reliance on Rule 701, an issuer must satisfy certain minimum disclosure requirements. Namely, the issuer must provide a copy of the relevant compensatory plan to all eligible recipients a reasonable time prior to the sale of securities (*e.g.*, for stock options, prior to the date of exercise; for all other equity awards, prior to the date of grant). Under the existing rule, if the aggregate sales price of securities sold by the issuer in reliance on Rule 701 exceeded \$5 million in a 12-month period (calculated as described above), then, in addition to providing recipients with a copy of the compensatory plan, the issuer must also provide additional enhanced disclosures to all eligible recipients, including:

- A summary of the material terms of the compensatory plan or compensatory contract;
- A list of risk factors associated with investing in the issuer's securities; and
- Financial statements of the issuer prepared in accordance with U.S. generally accepted accounting principles (GAAP) dated not more than 180 days before the sale.

The issuer's financial statements must be for the two most recently completed fiscal years or the period during which it has been in existence, if shorter. These financial statements must include consolidated balance sheets and statements of income, cash flows and changes in stockholders' equity. Interim financial statements also may be required to make sure that the date of the most recent financial statements is never more than 180 days before the securities are sold or issued. Companies may provide unaudited annual financial statements to comply with the Rule 701 disclosure obligation unless audited financial statements are available and the audit was conducted in accordance with U.S. GAAP or the standards of the Public Company Accounting Oversight Board.

Final Rule Amendment

Pursuant to the congressional mandate, the SEC amended Rule 701(e) to increase from \$5 million to \$10 million the aggregate sales price or amount of securities sold during any consecutive 12-month period in excess of which the issuer is required to deliver the enhanced disclosure to investors. Issuers that have commenced an offering in a current 12-month period will be able to apply the new \$10 million disclosure threshold immediately upon effectiveness of the amendment.

As amended, Rule 701(e) will otherwise continue to operate in the same manner as it currently does. That is, if aggregate sales during a 12-month period exceed \$10 million, the issuer must deliver the enhanced disclosures within a reasonable period of time before the event of sale date, which differs depending on the type of award. If the sale of securities involves stock options, the company must deliver the enhanced disclosures within a reasonable time before the date of the stock option exercise. If the sale of securities involves restricted stock or restricted stock units that are settled upon the satisfaction of a condition (*e.g.*, length of employment, performance targets), the company must deliver the enhanced disclosures within a reasonable time before the grant date of the award.

If sales in a Rule 701 offering exceed \$10 million in a 12-month period, and the required enhanced disclosures have not been provided to all investors before sale, the issuer will lose the exemption for the entire offering when sales exceed the \$10 million threshold. As is the case today, because of the risk of retroactive loss of the exemption, issuers should maintain robust controls to track the volume and expected timing of sales or grants under their equity compensation plans. An issuer that faces any risk of sales in excess of \$10 million in a 12-month period generally should provide the enhanced disclosures prior to all grant activity.

Conclusion

The ability of companies to more easily issue equity awards with greater value in lieu of cash compensation certainly is a welcome development, particularly for many early-stage companies. However, given the very modest increase in the enhanced disclosure threshold from \$5 million to \$10 million, we expect the impact of this rulemaking to be incremental.

Capital Markets Alert

Contacts

New York

Ryan J. Dzierniejko

Partner
212.735.3712
ryan.dzierniejko@skadden.com

Gregory A. Fernicola

Partner
212.735.2918
gregory.fernicola@skadden.com

David J. Goldschmidt

Partner
212.735.3574
david.goldschmidt@skadden.com

Laura A. Kaufmann Belkhat

Partner
212.735.2439
laura.kaufmann@skadden.com

Andrea L. Nicolas

Partner
212.735.3416
andrea.nicolas@skadden.com

Michael J. Schwartz

Partner
212.735.3694
michael.schwartz@skadden.com

Yossi Vebman

Partner
212.735.3719
yossi.vebman@skadden.com

Dwight S. Yoo

Partner
212.735.2573
dwight.yoo@skadden.com

Michael J. Zeidel

Partner
212.735.3259
michael.zeidel@skadden.com

Los Angeles

Michelle Gasaway

Partner
213.687.5122
michelle.gasaway@skadden.com

Palo Alto

Thomas J. Ivey

Partner
650.470.4522
thomas.ivey@skadden.com

Gregg A. Noel

Partner
650.470.4540
gregg.noel@skadden.com

Washington, D.C.

Brian V. Breheny

Partner
202.371.7180
brian.breheny@skadden.com

Andrew J. Brady

Of Counsel
202.371.7513
andrew.brady@skadden.com

Frankfurt

Stephan Hutter

Partner
49.69.74220.170
stephan.hutter@skadden.com

Hong Kong

Z. Julie Gao

Partner
852.3740.4863
julie.gao@skadden.com

Jonathan B. Stone

Partner
852.3740.4703
jonathan.stone@skadden.com

London

James A. McDonald

Partner
44.20.7519.7183
james.mcdonald@skadden.com

Danny Tricot

Partner
44.20.7519.7071
danny.tricot@skadden.com

Pranav L. Trivedi

Partner
44.20.7519.7026
pranav.trivedi@skadden.com

Singapore

Rajeev P. Duggal

Partner
65.6434.2980
rajeev.duggal@skadden.com

Sydney

Adrian J. S. Deitz

Partner
61.4294.44311
adrian.deitz@skadden.com

Tokyo

Kenji Taneda

Partner
81.3.3568.2640
kenji.taneda@skadden.com

Toronto

Riccardo A. Leofanti

Partner
416.777.4703
riccardo.leofanti@skadden.com

Associate **Jenna M. Godfrey** assisted in the preparation of this alert.