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SEC Solicits Comment on Modernizing the Rules and Forms for Stock-Based Compensation

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On July 18, 2018, the Securities and Exchange Commission (SEC) issued a [concept release](#) soliciting public comment on ways to modernize Rule 701 and Form S-8 of the Securities Act of 1933 to account for recent developments related to compensatory practices and the types of relationships between companies and individuals that provide services to such companies. The concept release is not a formal rule proposal but is expected to be the basis of future SEC rulemaking.

On the same date, the SEC amended Rule 701(e) of the Securities Act (which is available only to non-reporting issuers) to increase the dollar threshold from \$5 million to \$10 million for sales of securities that require issuers to deliver enhanced disclosures to employees. The change to Rule 701(e), which is now effective, is separately [discussed here](#).

Rule 701 Overview

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.

Under Rule 701, non-reporting companies can issue securities to employees and other covered persons (as further discussed below) without SEC registration so long as the securities are granted or issued pursuant to a written compensatory benefit plan, which would include an employment or, in certain cases, consulting agreement. Rule 701 is the most frequent exemption used by private companies to make compensatory equity awards.

Offering Size Limitations

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 on 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.

Disclosure Requirements

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 at 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 recently amended rule, if the aggregate sales price of securities sold by the issuer in reliance on Rule 701 exceeds \$10 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;
- the risk factors associated with an investment in the securities under the plan or agreement; 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 issued or sold. 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.

Eligible Recipients

Persons to whom offers and sales may be made pursuant to Rule 701 include: employees, officers and directors of the issuer (or the issuer's parent or majority-owned subsidiaries, or the majority-owned subsidiaries of the issuer's parent, each an "issuer-affiliated entity"). Recipients need not be accredited investors, as defined in Rule 501 of Regulation D under the Securities Act.

Consultants and advisors may also receive securities under Rule 701 so long as (i) such consultant or advisor is a natural person, providing bona fide services to the issuer or an issuer-affiliated entity; (ii) such services are not in connection with the offer or sale of securities in a capital-raising transaction; and (iii) the consultant or advisor does not directly or indirectly promote or maintain a market for the issuer's securities. Persons working under a *de facto* employment relationship with the issuer, such as a non-employee providing services that traditionally are performed by an employee, with compensation paid for those services being the primary source of the person's earned income, also would qualify as eligible persons under the exemption.

Rule 701 is not available for equity awards to entities (including, for example, entity consultants). Rule 701 only applies if the eligible recipient was employed by, or was providing services to, the issuer or an issuer-affiliated entity at the time the grant was made or the securities were initially offered.

Form S-8 Overview

For publicly reporting issuers that cannot use the Rule 701 exemption, Form S-8 provides an abbreviated registration statement for the issuance of compensatory securities under any employee benefit plan. As is the case with Rule 701, Form S-8 is available solely to register compensatory sales of securities to "employees," including consultants and advisors and *de facto* employees.¹ The form is not available for the registration of securities offered for the purpose of raising capital.

¹ However, where the consultant or advisor performs services for the issuer through a wholly owned corporate alter ego, the issuer may contract with, and register securities on Form S-8 as compensation to, that corporate entity. See Aaron Spelling Productions, Inc. (July 1, 1987).

Form S-8, which includes only certain limited disclosure obligations, was adopted primarily to streamline the registration process for public companies that issue securities for compensatory, rather than capital-raising, purposes. The accommodations available under Form S-8 include, most prominently: (i) immediate effectiveness of the registration statement upon filing without review by SEC staff; (ii) updating via forward incorporation by reference for all issuers (including those that are not eligible to use Form S-3); and (iii) no obligation to publicly file a statutory prospectus.

Concept Release

Expanding Eligible Recipients Under Rule 701 and Form S-8

The concept release solicits public comment on whether, and if so, how, to change Rule 701 and Form S-8 to account for the evolving employer-employee relationships of the so-called gig economy. These relationships can involve short-term, part-time or freelance arrangements where the individual, rather than the company, may set the work schedule. Often the individual uses the company's internet platform for a fee to find business, whether that involves providing services to end-users (such as ride shares, food delivery or household repairs) or using the platform to sell goods (such as craft objects or lodging).

Individuals participating in these arrangements typically do not enter into traditional employment relationships. Accordingly, they may not be "employees" eligible to receive securities in compensatory arrangements under Rule 701 or Form S-8. Similarly they may not be consultants, advisors or *de facto* employees under Rule 701 or Form S-8. Nevertheless, as with traditional employees, companies may wish to offer equity compensation to such individuals.

The concept release solicits comments on how Rule 701 or Form S-8 might be updated to account for such individuals and employee relationships. The SEC is asking for comments to be received on or before September 24, 2018.

Easing Rule 701 Disclosure Requirements

As noted in our [client alert](#) summarizing the recent amendment to Rule 701(e), if sales in a Rule 701 offering exceed \$10 million in a 12-month period, and the required enhanced disclosures described above 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. Because of the risk of retroactive loss of the exemption, issuers must maintain robust controls to track the volume and expected timing of sales or grants under their equity compensation plans. The concept release solicits public comment on whether, and if so, how, to change Rule 701 to address this potential concern, including whether the loss of the exemption should apply only to transactions that occur after the threshold is crossed and for which disclosure is not provided (thereby limiting any rescission claims against the issuer).

Under existing Rule 701, foreign private issuers are required to provide financial information on the same schedule as domestic issuers (*i.e.*, financial statements must be current within the past 180 days). Foreign private issuers may issue securities in reliance on Rule 701 throughout the year, which could effectively require them to update their financial statements more frequently than required under Form 20-F. The concept release solicits public comment on whether, and if so, how, Rule 701 should be tailored for foreign private issuers to conform with their home country practices to avoid this issue.

Treatment of RSUs Under Rule 701

The concept release solicits public comment on whether, and if so, how, to change the timing of the Rule 701 disclosure obligations tied to restricted stock unit (RSU) awards, which were not a common form of compensation at the time the rule was last updated.

Instruments such as RSUs settle by their terms without any action (*e.g.*, exercise or conversion) by the recipient. In the eyes of the SEC, the relevant investment decision tied to an RSU award, if there is one, "likely takes place at the date of grant." Consequently, an issuer's obligation to provide Rule 701(e) disclosure would apply a reasonable period of time before the grant date of the RSU award.

The concept release acknowledges commenters' concerns that disclosure of financial information before an RSU is granted could compel disclosure to recipients at a time when they are negotiating their employment contracts before joining the company. In response, the concept release seeks comment on when Rule 701(e) disclosure should be required for an RSU, and whether the timing should be different for new hires.

Capital Markets Alert

Raising or Eliminating the Offering Size Limitations on Rule 701 Sales

The concept release solicits public comment on whether, and if so, how, to change Rule 701 to raise or eliminate the offering size limitations on the aggregate sales price or amount of securities sold. The release notes that the current size limitations, which are a hard cap (and not to be confused with the Rule 701(e) thresholds that require the delivery of enhanced disclosures to employees), may unduly restrict smaller and start-up companies that may be more dependent on equity compensation to attract and retain necessary talent.

Streamlining or Eliminating Form S-8

The concept release solicits public comment on whether, and if so, how, to ease the requirements of Form S-8 and reduce the related compliance complexities and costs. The concept release identifies a range of potential reforms, including but not limited to:

- whether to reconsider the requirement to register a fixed number of shares, including as a means to avoid inadvertent Section 5 violations when plan sales exceed the number of shares registered (such as under a 401(k) plan where “share counting” issues are prevalent);
- whether to permit an issuer to register on a single form the offers and sales pursuant to all its employee benefit plans;

- whether to permit issuers to add securities to an effective Form S-8 via an automatically effective post-effective amendment; and
- whether to permit issuers to pay filing fees using a “pay-as-you-go” fee structure pursuant to which all issuers eligible to use Form S-8 could, at their option, pay filing fees on Form S-8 on an as-needed basis rather than when the form is initially filed.

The concept release also solicits public comment on more fundamental and comprehensive changes to the structure of compensatory-related securities offerings, including whether to extend the Rule 701 exemption to reporting companies and in turn eliminate Form S-8.

Conclusion

The concept release is aimed primarily at evaluating whether to update and streamline the regulatory framework governing compensatory securities offerings to accommodate changes in the workforce related to the gig economy and evolving forms of equity-based compensation. While the substance and timing of any changes remains uncertain, any responsive amendments to Rule 701 and/or Form S-8 could significantly alter the ways, and to whom, companies compensate their service providers.

Capital Markets Alert

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