SULLIVAN & CROMWELL LLP

July 20, 2018

SEC Increases Threshold for Additional Disclosure by Private Companies in Offerings of Securities to Employees; Solicits Comment on Ways to Modernize Rules and Forms for Compensatory-Related Offerings

Amendment to Rule 701 Increases from $5 Million to $10 Million the Annual Threshold at Which Private Companies Must Provide Additional Disclosure for Securities Offered and Sold Pursuant to Compensatory Arrangements; SEC Solicits Comments on Further Ways to Modernize Rule 701 and Form S-8

SUMMARY

On July 18, 2018, the SEC issued a final rule to amend Securities Act Rule 701, which provides an exemption from registration for securities offered and sold by companies not subject to the reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act") to their employees pursuant to compensatory arrangements. The amendment increases from $5 million to $10 million the threshold in excess of which an issuer is required to deliver additional disclosure, including financial disclosures, to investors under Rule 701.

In addition, the SEC issued a concept release soliciting public comment on possible ways to further modernize rules related to offerings pursuant to compensatory arrangements in light of recent trends in both the types of compensatory offerings and the relationships between companies and individuals providing services to such companies, noting a shift away from traditional employment and consulting

arrangements and the rise of the so-called "gig economy." In particular, the concept release solicits comments on potential further updates to Rule 701 as well as to Form S-8, which reporting companies use to register securities issued to employees and certain other service providers pursuant to compensation plans. Topics for which comments are being solicited include:

- Expanding eligible participants under Rule 701 and Form S-8 to account for employees in the "gig economy"
- Increasing the flexibility of Rule 701 disclosure requirements
- Addressing the treatment of restricted stock units under Rule 701
- Raising or removing the annual sales cap on Rule 701 transactions
- Simplifying, or potentially eliminating, Form S-8

In adopting the final rule and issuing the concept release, SEC Chairman Jay Clayton said, "the rule as amended, and the concept release, are responsive to the fact that the American economy is rapidly evolving, including the development of both new compensatory instruments and novel worker relationships—often referred to as the 'gig economy.' We must do all we can to ensure our regulatory framework reflects changes in our marketplace, including our labor markets."

BACKGROUND

Rule 701

Rule 701 provides an exemption from the registration requirements of the Securities Act of 1933 (the "Securities Act") for offers and sales of securities under certain compensatory benefit plans or written agreements relating to compensation. The exemption covers securities offered or sold under a plan or agreement between a non-reporting company[1] and the company's employees, officers, directors, partners, trustees, consultants and advisors.

In adopting the original rule, the SEC determined it would be an unreasonable burden to require non-reporting companies, many of which are small businesses, to incur the disclosure obligations of public companies for sales of securities to employees.[2] In addition to domestic non-reporting companies, Rule 701 is also available to foreign private issuers.

Amount of Securities that May Be Sold. Rule 701 provides that the amount of securities that may be sold in reliance on the exemption during any consecutive 12-month period is limited to the greatest of: (1) $1 million; (2) 15% of the total assets of the issuer, measured at the issuer's most recent balance sheet date; and (3) 15% of the outstanding amount of the class of securities being offered and sold in reliance on the Rule, measured at the issuer's most recent balance sheet date.[3] For securities underlying options, the aggregate sales price is determined when the option grant is made, without regard to when it

becomes exercisable.[4] For deferred compensation plans, the calculation is made at the time of the participant's irrevocable election to defer.[5]

Disclosure Obligations. In all cases, issuers relying on Rule 701 must deliver to investors a copy of the compensatory benefit plan or contract.[6] In addition, if the aggregate sales price or amount of securities sold during the 12-month period exceeds $5 million (now $10 million pursuant to the amendment described below), the issuer must provide additional disclosure, including (1) a copy of the summary plan description required by the Employee Retirement Income Security Act of 1974 ("ERISA") (or a summary of the plan's material terms if not subject to ERISA), (2) risks associated with the securities and (3) financial statements required to be furnished under Regulation A.[7]

This disclosure should be provided to all investors before the sale of the securities. If this disclosure is not provided to all investors before the sale, the issuer could lose the exemption for the entire offering when sales exceed the $5 million threshold (now $10 million) during the 12-month period.

Eligible Employees and Service Providers. The exemption covers securities offered or sold under a plan or agreement between a non-reporting company and its employees, officers, directors, partners, trustees or consultants and advisors.[8] Consultants and advisors may participate in Rule 701 offerings only if they are natural persons, provide bona fide services to the issuer and the services are not in connection with a capital-raising transaction and do not promote or maintain a market for the issuer's securities.[9]

The SEC has also provided guidance that a person in 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, would qualify as an eligible person under the exemption.[10]

Form S-8

Form S-8 is used for the registration of securities offered under any employee benefit plan (including 401(k) plans, employee stock purchase plans and equity incentive plans) to a registrant's employees and certain other service providers (including certain insurance agents). Form S-8 is used by reporting companies, specifically any issuer that is subject, at the time of filing, to the periodic reporting requirements of Section 13 or 15(d) of the Exchange Act and that has filed all reports required during the preceding 12 months. The availability of a separate registration form underscores the policy position that the offer and sale of securities to employees and certain other service providers as part of compensation arrangements presents different considerations than the offer and sale of securities for the purpose of capital raising.

Form S-8 is available solely to register compensatory sales of securities to employees, which, similar to Rule 701, includes directors, general partners, trustees, consultants and advisors as well as "de facto" employees.[11] Issuers register a specific number of company shares on Form S-8.

From time to time, the SEC has amended Form S-8 to simplify or streamline its operations, such as providing immediate effectiveness upon filing and updating of the registration statement through incorporation by reference.[12]

AMENDMENT TO RULE 701

The final rule[13] 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 the issuer is required to deliver additional disclosures to investors.[14] The amendment was mandated by the Economic Growth, Regulatory Relief and Consumer Protection Act,[15] which Congress adopted in May 2018 as part of efforts to update the Dodd-Frank Wall Street Reform and Consumer Protection Act.

As amended, Rule 701(e) otherwise will continue to operate in the same manner as it currently does. Specifically, if aggregate sales during the 12-month period exceed $10 million, the issuer must deliver the additional disclosures a reasonable period of time before the date of sale to all investors in the 12-month period. Issuers that have commenced an offering in the current 12-month period will be able to apply the new $10 million disclosure threshold immediately upon the effectiveness of the amendment.

The updated regulation will become effective once it is published in the Federal Register.

CONCEPT RELEASE ON MODERNIZING COMPENSATORY-RELATED OFFERINGS

The concept release[16] highlights significant changes that have taken place in recent years, both in the types of compensatory offerings issuers make and the relationship they have with their employees and workforce. For example, forms of equity compensation that were not typically used when Rule 701 was last substantively revised in the late 1990s, such as restricted stock units ("RSUs"), have become common. New types of contractual relationships between companies and individuals involving alternative work arrangements have also recently emerged, identified by the SEC as the so-called "gig economy," due in large part to the internet and smartphone technology. In light of these changes, the SEC is soliciting comments on Rule 701 and Form S-8 to determine whether and, if so, how, the rules should be updated to accommodate the changing landscape.

The concept release provides instructions for the submission of comments, which will be accepted for 60 days following the publication of the release in the Federal Register. Sullivan & Cromwell anticipates commenting.

Expanding Eligible Participants under Rule 701 and Form S-8 to Account for the "Gig Economy"

The concept release solicits comments to consider how Rule 701 and Form S-8 requirements could be updated to account for the changing employer-employee relationships of the "gig economy." Such relationships can involve short-term, part-time or freelance arrangements where an individual uses the company's internet platform for a fee to find business, whether that involves providing services to end users (such as ride-sharing, food delivery, household repair services) or using the platform to sell goods (such as selling craft objects or lodging).

Individuals participating in these arrangements often do not enter into traditional employment relationships. They therefore may not be "employees" eligible to receive securities in compensatory arrangements under Rule 701 of Form S-8. Similarly they may not be consultants, advisors or "de facto" employees under Rule 701 or Form S-8. As with traditional employees, however, 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. Related questions that the SEC's comment requests focus on include:

- To what extent should definitions of "employee" under other regulatory regimes guide the SEC's thinking on eligible participants in compensatory securities offerings?
- Should the SEC consider some type of test that identifies eligible participants as individuals who use the company's platform to secure work to provide services to end users? Are there other factors necessary to establish some level of control by the issuer over the work?
- Should it matter what percentage of the individual's earned income is derived from using the issuer's platform or to what extent the issuer's business is dependent on individuals' use of the platform?
- For Rule 701 purposes, what activities should an individual need to engage in to be eligible to participate in exempt compensatory offerings under Rule 701? Would extending eligibility to individuals participating in the "gig economy" affect a company's decision to stay private?
- If the scope of individuals who are eligible for Form S-8 offerings were expanded, would there be concerns about misuse of the form for capital-raising activities?
- Would differences between the eligibility standards of Rule 701 and Form S-8 cause problems for issuers or recipients?

Increasing Flexibility of Rule 701 Disclosure Requirements

As described above, 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 12-month period in excess of which the issuer is required to deliver additional disclosures to investors.

The amendment, however, does not otherwise revise Rule 701(e). In particular, although the threshold for additional disclosure is higher, the need for an issuer to anticipate the consequences of crossing it

remains. In circumstances where the required disclosure is not provided to all investors before the $10 million threshold is crossed, issuers may not be able to rely on the exemption. Crossing the disclosure threshold could result in the loss of exemption for earlier Rule 701 transactions in the same 12-month period for which the disclosure was not provided before sale. Accordingly, the current structure of the Rule, as amended, results in issuers needing to anticipate, up to 12 months before exceeding the $10 million threshold, the possibility that they may do so. The concept release seeks comments on how Rule 701 could be updated to address this potential concern.

The concept release also notes other issues related to Rule 701 disclosure, such as that many non-reporting companies are not familiar with Regulation A financial disclosures, which are triggered upon crossing the threshold. Also, beyond needing to be delivered to investors "a reasonable period of time before the date of sale," the timing and manner of disclosure is not specifically prescribed under Rule 701(e).

In light of these concerns, the concept release seeks comments regarding several questions, including:

- Should Rule 701(e) continue to require more disclosure for a period that precedes the threshold amount being excluded?
- Should the consequence for failing to provide the disclosure be loss of the exemption only for transactions in offerings that occur after the threshold is crossed or should there be a grace period?
- Should the Regulation A financial statements disclosure requirements depend on what type of employee is the recipient of the securities? Should the SEC consider other alternatives to the Regulation A financial statements?
- Should the SEC clarify or change the requirements relating to the timing, manner or medium of the disclosure?

Addressing RSUs under Rule 701

The concept release also requests comments on whether Rule 701 should specifically address RSUs, which were not a common form of equity compensation when the Rule was last substantively amended.

For options and other derivative securities, whether the issuer is required to deliver Rule 701(e) disclosure is based on whether the option or other derivative security was granted during a 12-month period in which the disclosure threshold is exceeded. If so, the issuer must deliver the disclosure in a reasonable period of time before the date of exercise or conversion, *i.e.*, the date for which the recipient must make an investment decision.

Unlike options, however, RSUs settle without the recipient making an investment decision. The concept release notes, therefore, that the relevant investment decision for a recipient of an RSU (if there is one) likely takes place at the date of grant. Consequently, the issuer's obligation to provide Rule 701(e) disclosure would be a reasonable period of time before the date the RSU is granted. The concept

release says concerns have been expressed 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.

The concept release seeks comments regarding whether Rule 701 should be amended to specifically address RSUs and similar instruments, including on the following questions:

- When should Rule 701(e) disclosure be required for an RSU award, and should the timing be different for awards to new hires?
- Should the SEC clarify how RSUs should be valued for Rule 701 purposes?

Raising or Removing Annual Sales Cap on Rule 701 Transactions

The concept release also solicits comments on whether the current 12-month sales cap of the greater of 15% of the total assets of the issuer and 15% of the total outstanding amount of the class of securities being offered and sold in reliance on Rule 701, subject to an annual cap of $1 million if greater than either of these tests, is too restrictive. The release notes the current cap may be of special concern to smaller and start-up companies that may be more dependent on equity compensation to attract and retain necessary talent. The release solicits comment on whether there is any continuing need for any annual regulatory ceiling for Rule 701 transactions and if so, if the current ceiling should be raised.

Simplifying Form S-8 Requirements

In focusing on Form S-8, the concept release states that the SEC remains "interested in simplifying the requirements of Form S-8 and reducing the complexity and cost of compliance" for issuances of securities to employees and other eligible participants under the form.

The questions for which comments are solicited cover a range of topics dealing with how burdens associated with registration on Form S-8 could be reduced. These questions include:

- Should the requirement to register a specific number of shares be changed?
- Should issuers be able to add securities to the existing Form S-8 by an automatically effective post-effective amendment?
- Should Form S-8 allow an issuer to register on a single form the offers and sales pursuant to all its employee benefit plans? Would this be practicable where the securities to be registered relate to different types of plans (such as 401(k) and incentive plans)?
- Should the filing fee rules for Form S-8 be changed, such as to a "pay-as-you-go" fee pursuant to which issuers could pay filing fees on an as-needed basis rather than when the form is originally filed? Alternatively, should the registration fees be paid on a periodic basis for securities sold during some prior period?

Potential Overhaul or Elimination of Form S-8

Finally, the concept release includes several additional questions for comment related to more sweeping, broad-based changes to the structure of compensatory-related securities offerings, including raising the prospect of eliminating Form S-8 altogether. The questions the SEC proposes include the following:

- Does the current operation of Form S-8 present significant challenges to the use of employee benefit plans?
- What would be the advantages and disadvantages if the SEC were to extend the Rule 701 exemption to reporting companies and in turn eliminate Form S-8? Would this raise any investor protection concerns?
- If the SEC permits reporting companies to use Rule 701, should it require those companies to be current in their Exchange Act reports (as they are currently required to do to use Form S-8) in order to use the exemption?
- If Form S-8 were rescinded, how would issuers be likely to register the resale of restricted securities issued pursuant to employee benefit plans?

IMPLICATIONS

While the final rule increasing the threshold for Rule 701 disclosure is a discrete change and one that was legislatively mandated, the concept release suggests that the SEC is focused on revisiting more broadly the registration rules and structure of compensatory-related offerings, which have not been substantively amended in nearly 20 years. The solicitation of comments largely appears to be driven by an attempt to better understand, and adapt the regulatory framework to accommodate, changes in the workforce related to the "gig economy" and modern forms of equity compensation such as RSUs, which should be viewed positively by employers and employees alike. The wide-ranging scope of the concept release, particularly its solicitation of comments regarding the potential overhaul or elimination of the requirement to register securities offered under employee benefit plans on Form S-8, is also noteworthy and illustrates the SEC's stated objectives of striving for innovative, flexible and pragmatic regulatory approaches that recognize the ever-changing nature of the capital markets.[17]

* * *

ENDNOTES

1 Only issuers that are not subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act and are not investment companies registered or required to be registered under the Investment Company Act of 1940 are eligible to rely on Rule 701.

2 *See* "Employee Benefit and Compensation Contracts," SEC Release No. 33-6726 (July 30, 1987) at Section I.

3 Rule 701(d).

4 Rule 701(d)(3)(ii).

5 *Id*.

6 Rule 701(e).

7 *Id.* The required financial statements must be as of a date no more than 180 days before the sale.

8 Rule 701(c).

9 *Id.*

10 *See* "Rule 701—Exempt Offerings Pursuant to Compensatory Arrangements," Release No. 33-7645 (Feb. 25, 1999) at Section II.D ("1999 Adopting Release").

11 In 1999, the SEC revised the eligibility standards for "consultants and advisors" for the purposes of Form S-8, and at the same time revised the same Rule 701 definition to be consistent with Form S-8. In adopting these changes, the SEC noted that issuers may continue to use securities registered on From S-8, or issued under the Rule 701 exemption, to compensate persons with whom they have a "de facto" employment relationship. *See id*.; "Registration of Securities on Form S-8," SEC Release No. 33-7646 (Feb. 25, 1999).

12 *See, e.g*., "Registration and Reporting Requirements for Employee Benefit Plan," SEC Release No. 33-6867 (June 6, 1990).

13 SEC Release No. 33-10520 (July 18, 2018).

14 The additional disclosures include a copy of the summary plan description required under ERISA, or, if the plan is not subject to ERISA, a summary of the plan's material terms, risk factors associated with investment in the securities and financial statements.

15 Pub. L. 115-174, 132 Stat. 1296 (2018).

16 SEC Release No. 33-10521 (July 18, 2018).

17 SEC Draft Strategic Plan 2018-2022, available at https://www.sec.gov/files/sec-strategic-plan-2018-2022.pdf.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.

CONTACTS

New York

Ari B. Blaut	+1-212-558-1656	blauta@sullcrom.com
Robert E. Buckholz	+1-212-558-3876	buckholzr@sullcrom.com
Catherine M. Clarkin	+1-212-558-4175	clarkinc@sullcrom.com
Heather L. Coleman	+1-212-558-4600	colemanh@sullcrom.com
Donald R. Crawshaw	+1-212-558-4016	crawshawd@sullcrom.com
Robert G. DeLaMater	+1-212-558-4788	delamaterr@sullcrom.com
Robert W. Downes	+1-212-558-4312	downesr@sullcrom.com
John E. Estes	+1-212-558-4349	estesj@sullcrom.com
William G. Farrar	+1-212-558-4940	farrarw@sullcrom.com
Jared M. Fishman	+1-212-558-1689	fishmanj@sullcrom.com
Matthew M. Friestedt	+1-212-558-3370	friestedtm@sullcrom.com
Sergio J. Galvis	+1-212-558-4740	galviss@sullcrom.com
Marion Leydier	+1-212-558-7925	leydierm@sullcrom.com
Christopher L. Mann	+1-212-558-4625	mannc@sullcrom.com
S. Neal McKnight	+1-212-558-3316	mcknightn@sullcrom.com
John P. Mead	+1-212-558-3764	meadj@sullcrom.com
Scott D. Miller	+1-212-558-3109	millersc@sullcrom.com
Inosi M. Nyatta	+1-212-558-7822	nyattai@sullcrom.com
Regina L. Readling	+1-212-558-4020	readlingr@sullcrom.com
Robert W. Reeder III	+1-212-558-3755	reederr@sullcrom.com

James M. Shea Jr.	+1-212-558-4924	sheaj@sullcrom.com
Rebecca J. Simmons	+1-212-558-3175	simmonsr@sullcrom.com
William D. Torchiana	+1-212-558-4056	torchianaw@sullcrom.com
Marc Trevino	+1-212-558-4239	trevinom@sullcrom.com
Benjamin H. Weiner	+1-212-558-7861	weinerb@sullcrom.com
Washington, D.C.		
Rebecca S. Coccaro	+1-202-956-7690	coccaror@sullcrom.com
Robert S. Risoleo	+1-202-956-7510	risoleor@sullcrom.com
Los Angeles		
Patrick S. Brown	+1-310-712-6603	brownp@sullcrom.com
Rita-Anne O'Neill	+1-310-712-6698	oneillr@sullcrom.com
Alison S. Ressler	+1-310-712-6630	resslera@sullcrom.com
Palo Alto		
Scott D. Miller	+1-650-461-5620	millersc@sullcrom.com
Sarah P. Payne	+1-650-461-5669	paynesa@sullcrom.com
John L. Savva	+1-650-461-5610	savvaj@sullcrom.com
London		
Chris Beatty	+44-20-7959-8505	beattyc@sullcrom.com
Vanessa K. Blackmore	+44-20-7959-8480	blackmorev@sullcrom.com
Kathryn A. Campbell	+44-20-7959-8580	campbellk@sullcrom.com
Oderisio de Vito Piscicelli	+44-20-7959-8589	devitopiscicellio@sullcrom.com
John Horsfield-Bradbury	+44-20-7959-8491	horsefieldbradburyj@sullcrom.com
John O'Connor	+44-20-7959-8515	oconnorj@sullcrom.com
David Rockwell	+44-20-7959-8575	rockwelld@sullcrom.com
Paris		
Olivier de Vilmorin	+33-1-7304-5895	devilmorino@sullcrom.com
William D. Torchiana	+33-1-7304-5890	torchianaw@sullcrom.com
Frankfurt		
Carsten Berrar	+49-69-4272-5506	berrarc@sullcrom.com
Krystian Czerniecki	+49-69-4272-5525	czernieckik@sullcrom.com
Wolfgang Feuring	+49-69-4272-5511	feuringw@sullcrom.com

Melbourne		
Robert Chu	+61-3-9635-1506	chur@sullcrom.com
Sydney		
Waldo D. Jones Jr.	+61-2-8227-6702	jonesw@sullcrom.com
Tokyo		
Izumi Akai	+81-3-3213-6145	akaii@sullcrom.com
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com
Hong Kong		
Garth W. Bray	+862-2826-8691	brayg@sullcrom.com
Ching-Yang Lin	+862-2826-8606	linc@sullcrom.com
Kay lan Ng	+852-2826-8601	ngki@sullcrom.com
Chun Wei	+852-2826-8666	weic@sullcrom.com
Beijing		
Gwen Wong	+86-10-5923-5967	wonggw@sullcrom.com