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Legal Update

# Proposed Amendments to Rule 701 and Form S-8; Proposed Temporary Rule for Certain Equity-Based Compensation Grants

On November 24, 2020, the US Securities and Exchange Commission (SEC) proposed for comment amendments to Rule 701 under the Securities Act of 1933, which is the exemption from the registration requirements relied upon most frequently by non-reporting companies in connection with their issuances of stock-based compensation to employees, as well as amendments to the Form S-8 registration statement, which is used to register compensatory offerings by reporting companies.[1] In a separate release also issued on November 24, 2020,[2] the SEC has proposed to expand Rule 701 and the use of Form S-8 to facilitate compensatory transactions with platform workers for a five-year period.

## Background

The dynamics relating to equity awards have changed in significant ways in recent years. More and more companies are remaining private longer and deferring initial public offerings or other liquidity events. As a result, employees and consultants may hold their equity-based compensation awards for longer periods than they would have previously. Private companies are becoming significantly larger and have more dispersed holders. Companies have a wider variety of employment models, including models that depend on the use of shift or "gig" workers. In part as a result of a view that Rule 701 had not kept pace with these changes, federal legislation in 2018 mandated that the SEC amend the dollar threshold in aggregate sales price or amount of securities sold by an issuer that triggers the requirement in Rule 701 for additional disclosures to be delivered to holders.[3] Also in 2018, the SEC issued its Concept Release on Compensatory Securities Offerings and Sales (Concept Release) in which it sought comment on ways to modernize the Rule 701 exemption and relationship between Rule 701 and Form S-8 among other things.[4] Based, in part, on the public comments received in response to the Concept Release, the SEC has proposed a number of changes.

## Rule 701 Proposed Changes

### DISCLOSURE REQUIREMENTS

The SEC proposed several disclosure-related changes to Rule 701. For example, the SEC proposed to amend Rule 701(e) to revise the disclosure requirements for transactions where the aggregate sales price or amount of securities sold in any consecutive 12-month period exceeds $10 million, so that the issuer must deliver the additional disclosure required by the rule only with respect to those sales that exceed the $10 million

threshold. The exemption would remain available for all sales that exceed the $10 million threshold during the 12-month period if the issuer provides the required disclosures for those sales.

## AGE OF FINANCIAL STATEMENTS

The SEC proposed to conform the age of financial statement requirement in Rule 701(e) to the corresponding requirement in Part F/S of Form 1-A. This change, if adopted, would be applicable at the time of sale and available to both domestic and foreign issuers. Financial statements would need to be available on at least a semi-annual basis and completed within three months after the end of the second and fourth quarters.

## FOREIGN PRIVATE ISSUERS

The SEC proposed to allow foreign private issuers that are eligible for the Securities Exchange Act of 1934 (Exchange Act) Rule 12g3-2(b) exemption from Exchange Act registration to provide financial statements using home country accounting standards if financial statements prepared in accordance with generally accepted accounting principles in the United States (US GAAP) or International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS) are not otherwise available.

## ALTERNATIVE VALUATION DISCLOSURE

The SEC proposed to allow issuers to provide alternative valuation information, specifically an independent valuation report of the securities' fair market value as determined by an independent appraisal consistent with the rules and regulations under Internal Revenue Code Section 409A applicable to determining the fair market value of service recipient stock for stock not tradeable on an established securities market in lieu of financial statements for purposes of Rule 701(e) disclosure (for all issuers other than foreign private issuers eligible for the Exchange Act Rule 12g3-2(b) exemption) subject to certain conditions. While this alternative could be very helpful for issuers who choose to obtain such a valuation as part of a grant of stock options or otherwise, it is important to note key differences between the SEC proposal and the Section 409A rules. The SEC proposal requires the appraisal to be no more than six months old (while Section 409A permits such a report to be used for up to one year if no material facts have changed with respect to the issuer), and the SEC proposal requires the entire report to be given to the employee (while Section 409A does not require any disclosure of the valuation to the employee).

## DISCLOSURE REQUIREMENT FOR DERIVATIVE SECURITIES

The proposing release notes that over time more equity-based compensation instruments have developed that no longer involve a decision by the recipient to exercise or convert, such as a restricted stock unit (RSU). With respect to such derivative instruments that do not involve a decision on the part of the recipient whether to exercise or convert, the SEC proposed to clarify the distinction between derivative securities that involve a decision by the recipient to exercise or convert and those that do not with respect to the timing requirement for providing disclosure under Rule 701(e). If a sale involves an option or other derivative security that involves a decision to exercise or convert, the issuer would continue to be required to deliver disclosure a reasonable period of time *before the date of exercise or conversion*; if the sale involves an RSU or other derivative security that does not involve a decision to exercise or convert, the issuer generally would continue to be required to deliver disclosure a reasonable period of time before a period of time *before the date the RSU or similar derivative security is granted*. The SEC also proposed to modify the timing

requirement for providing disclosure under Rule 701(e) for grants to new hires in specified circumstances. With respect to the grant of an RSU or similar instrument, the disclosure would be considered delivered a reasonable period of time before the date of sale if it is provided no later than 14 calendar days after the date the employee begins employment.

## BUSINESS COMBINATIONS

The SEC proposed to amend Rule 701(e) to address the application of the exemption and the disclosure delivery obligations to target entity derivative securities that the acquiring issuer assumes in a business combination transaction.

## RULE 701(d) REGULATORY CEILINGS

The current rule provides that in any consecutive 12-month period the amount of securities sold in reliance on the exemption is limited to the greatest of:

- $1 million;
- 15% of the total assets of the issuer, measured at the issuer's most recent balance sheet date; or
- 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.

The SEC has proposed two revisions. First, it would raise the $1 million cap to $2 million. Second, it would raise the asset cap to 25% 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 (if no older than its last fiscal year end). The third cap related to the amount of the class of securities being offered and sold would be retained with no changes.

## ELIGIBLE RECIPIENTS

The proposed amendments would extend Rule 701 consultant and advisor eligibility for the first time to entities that meet specified ownership criteria designed to assure that the securities compensate for the performance of services subject to the following conditions:

- 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.

The SEC would also propose to expand Rule 701 eligibility for former employees to specified post-termination grants and to former employees of acquired entities.

The proposed amendments also would modify Rule 701(c) by substituting the term "subsidiaries" for "majority-owned subsidiaries" to make the exemption available for offers and sales of securities under a compensation plan established by the issuer, its subsidiaries, or subsidiaries of the issuer's parents.

## Registration Statement on Form S-8

The SEC also proposed several amendments to Form S-8 in order to modernize and simplify the form. The proposed amendments include, among others, the following:

- Conforming other provisions to the proposed changes to Rule 701, including extending Form S-8 eligibility to consultant and advisor entities meeting specified ownership criteria and in specified circumstances to former employees of a company and former employees of acquired entities;
- Explicitly clarifying that the form can be used to register securities pursuant to multiple plans on a single registration statement;
- Allowing the addition of new plans to an existing registration statement by filing an automatically effective post-effective amendment;
- Clarifying that an issuer is not required to allocate registered securities among incentive plans, but the issuer would still need to track securities sold under each plan;
- Changing the timing of the payment and the calculation of the amount of the registration fee for offerings of securities pursuant to defined contribution plans;
- Allowing an issuer to file an amendment to add securities to an existing S-8 by filing an automatically effective post-effective amendment; and
- Modifying the fee calculations and payment methods for sales made pursuant to defined contribution plan offerings as well as for various other purposes.

## Proposed Temporary Rules to Include Certain "Platform Workers" in Compensatory Offerings under Rule 701 and Form S-8

The SEC is proposing a limited five-year time period in order to be able to assess the effectiveness of the proposed exemption and understand how the exemption is being used. Given that an issuer has a different relationship with a platform worker than the relationship it generally has with a permanent employee, and the possibility that a platform worker may work for various companies at the same time and may view its relationship with each such company differently than an employee might view its relationship with an employer, the SEC's proposed exemption imposes additional safeguards. An eligible platform worker would be required to be a natural person or an entity meeting specified conditions. In addition, the proposed exemption would be available to offer securities on a compensatory basis to platform workers who, pursuant to a written contract or agreement, provide bona fide services by means of an internet-based platform or other widespread, technology-based marketplace platform or system provided by the issuer if:

- The issuer operates and controls the platform, as demonstrated by its ability to provide access to the platform, to establish the principal terms of service for using the platform and terms and conditions by which the platform worker receives payment for the services provided through the platform, and to accept and remove platform workers participating in the platform;

- The issuance of securities to participating platform workers is pursuant to a compensatory arrangement, as evidenced by a written compensation plan, contract, or agreement, and is not for services that are in connection with the offer or sale of securities in a capital-raising transaction, or services that directly or indirectly promote or maintain a market for the issuer's securities;
- No more than 15% of the value of compensation received by a participating worker from the issuer for servicers provided by means of the platform during a 12-month period, and no more than $75,000 of such compensation received from the issuer during a 36-month period, shall consist of securities, with such value determined at the time the securities are granted;
- The amount and terms of any securities issued to a platform worker may not be subject to individual bargaining or the worker's ability to elect between payment in securities or cash; and
- The issuer must take reasonable steps to prohibit the transfer of the securities issued to a platform worker pursuant to this exemption, other than a transfer to the issuer or by operation of law.

In order to help the SEC to evaluate the proposed expanded scope of the exemption applicable to these types of workers, an issuer that relies on the exemption would be required to furnish certain information relating to these grants to the SEC every six months.

## PRACTICAL CONSIDERATIONS

While in recent years the Staff of the SEC's Division of Corporation Finance has provided guidance through multiple Compliance & Disclosure Interpretations relating to the application of Rule 701 in various contexts, including in the context of business combinations, these proposed amendments represent the first significant changes to an exemption that is fundamental to private companies. As a result, they bear close consideration and review.

The proposed temporary expansion of Rule 701 and Form S-8 represents the first attempt by the SEC to expand these provisions to address compensatory arrangements to certain platform workers. Interested persons should review the proposal and provide comments to help make sure that any provision that is adopted is workable in practice. In addition, in a joint statement,[5] two Commissioners felt that there was no justification provided for distinguishing certain platform workers from other alternative work arrangements. As a result, it will be interesting to see how commenters feel about this proposal and whether the universe of eligible arrangements will be expanded.

The comment period for each proposal will be open for 60 days following publication of the proposing releases in the Federal Register.

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## Endnotes

[1] *See* https://www.sec.gov/rules/proposed/2020/33-10891.pdf.

[2] *See* https://www.sec.gov/rules/proposed/2020/33-10892.pdf.

[3] For more information on the Concept Release, see our Legal Update, "SEC Issues Concept Release on Compensatory Offerings," dated July 25, 2020, available at https://www.mayerbrown.com/en/perspectives-events/publications/2018/07/sec-issues-concept-release-on-compensatory-offerin.

[4] For more information on the Concept Release, see our Legal Update, "SEC Issues Concept Release on Compensatory Offerings," dated July 25, 2020, available at https://www.mayerbrown.com/en/perspectives-events/publications/2018/07/sec-issues-concept-release-on-compensatory-offerin.

[5] *See* https://www.sec.gov/news/public-statement/lee-crenshaw-701-2020-11-24.