ROBERT G. HUTCHINS - LEGAL BULLETINS

October 2010 - SEC Rule 701 - Registration Exemption for Securities Issued as Compensation

Overview

Companies, both public and private, routinely issue securities as compensation. Typically, this is done under a formal plan in which the company, as issuer, offers to make its securities available to participants in exchange for their performance (or continued performance) of agreed services. The offer is made by granting the participants options or rights to obtain the securities as deferred or bonus compensation or to purchase the securities on favorable terms. The options are themselves securities. Because the resulting transactions involve the offer and sale of securities, they must be registered at both the federal and state levels unless an exemption is available. Public companies file registration statements for these transactions. Private companies may rely on SEC Rule 701 to obtain an exemption from federal registration. Most states have counterpart exemptions. See, "State Exemptions," below page 3.

Rule 701 has an uneven and somewhat confusing history. Section 3(a) of the Securities Act of 1933 exempts various classes of securities from federal registration, and Section 4 exempts various transactions, but neither Section mentions stock options or similar compensation plans. Section 3(b), however, authorizes the SEC to add new classes of securities to those already exempted if it finds that registration of the added class is not necessary "in the public interest and for the protection of investors" because of "the small amount involved or the limited character of the public offering." The Section limits the "small amount" to a maximum of $5,000,000. The SEC limits the "character" of the offering through regulations that require disclosure, prohibit "general solicitations" of investors and restrict resales.[1]

Rule 701 was adopted originally by the SEC under Section 3(b) and as a result the maximum amount of securities that could be issued under the Rule initially was $5,000,000. More than a few securities compensation plans currently in effect still carry that limitation. In 1996, though, Congress added Section 28 to the Securities Act. The latter Section gave the SEC authority to create exemptions in excess of $5,000,000 and in 1999 the SEC responded by replacing the original ceiling on Rule 701 transactions with the formulation summarized on page 2 under the caption "Applicable Dollar Limits."

In its present form, the Rule provides a transactional exemption from federal registration for offers and sales of securities and rights to acquire them made by private issuers to eligible participants pursuant to an "Employee Benefit Plan." The SEC defines that term to include any written "purchase, savings, option, bonus, appreciation, profit sharing, thrift, incentive, pension or similar plan or compensation contract solely for employees, directors, general partners, trustees, officers or consultants or advisers." Rule 701 does not exempt other types of securities transactions, such as offerings made for the purpose of raising capital, but neither is it exclusive. Private issuers of compensatory securities may claim any other available exemption if they fail to satisfy the Rule. Moreover, offerings under Rule 701 are discrete for legal purposes. They will not be combined ("integrated") with other offerings by the same issuer.[2]

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[1] See, e.g., Rule 502 of Regulation D. The Rules and Regulations cited here are available on the SEC website at www.sec.gov. Click, in succession, "*About the SEC/Laws & Regulations/Rules and Regulations/Securities Act of 1933/Part 230.*" Then scroll down to the relevant Rule.

[2] The terminology relevant to Rule 701 is not consistent. The definition of "Employee Benefit Plan" quoted above is found in Rule 405, which applies generally to the Securities Act, its Rules and Regulations. Rule 701, by contrast, is captioned "Compensation Benefit Plan Exemption." Rule 701(c) refers to the transactions exempted by the Rule as offers and sales "under a written compensatory benefit plan (or written compensation contract)." This Bulletin uses the term "Employee Benefit Plan" to describe any compensation arrangement that satisfies the Rule.

Rule 701 Technical Requirements

The Issuer

Rule 701 is available only for private issuers that are neither reporting companies under the Securities Exchange Act nor investment companies registered or required to be registered under the Investment Company Act. The Rule does permit a public company to *guaranty* the obligations respecting a subsidiary's securities validly offered and sold under the Rule. Moreover, Rule 701(b)(2) provides, in effect, that the status of the issuer as a private company is determined when the securities are *offered*; not when they are *issued*. The SEC has confirmed this stating that if an issuer becomes subject to Exchange Act reporting after offering securities in compliance with the Rule, e.g., stock options that could not be exercised until the issuer went public, it may still rely on the Rule to issue the stock. Conversely, a public issuer that is not an investment company, and that suspends or terminates its Exchange Act reporting obligations, may *thereafter* rely on Rule 701.[3]

Exempted Transactions - Qualified Sponsors and Eligible Participants

No notice need be filed with the SEC to claim a Rule 701 exemption. To comply with the Rule, an Employee Benefit Plan must be a written compensatory plan "established" by the issuer, its parent, any of the issuer's majority-owned subsidiaries or any of the majority-owned subsidiaries of the issuer's parent. The securities included in the Plan may be offered and sold to the employees, directors, officers, general partners, trustees (if the issuer is a business trust), consultants or advisors of the foregoing entities and any family members of those persons who acquire their interests by gift or a domestic relations order.

Former employees, directors, etc. are eligible if they were employed or providing bona fide services to the issuer or a qualified affiliate when the securities were offered. Independent consultants and advisers are eligible only if they are natural persons who provide such services for other than a capital-raising transaction or the establishment or maintenance of a market for the issuer's securities. "Family members" are defined broadly and include lineal descendants, siblings, nieces, nephews, spouses, in-laws, adoptees, persons other than tenants or employees who share the household of an eligible person and trusts, foundations or other entities in which an eligible person owns more than fifty percent of the voting interests. Non-employee sales representatives, franchisees and independent insurance agents, however, though originally eligible under the Rule, were excluded by the 1999 amendments.

Applicable Dollar Limits

The precise offer made under an Employee Benefit Plan is of the right to receive a fixed or formula-derived number of the issuer's securities in exchange for specified services. Because the pool of securities included in the Plan must be large enough to cover all eligible participants, and the securities may be issued only over an extended period, Rule 701 does not limit the dollar amount of the offers. Instead, the Rule limits the "aggregate sales price or amount of securities" the issuer *sells* during any consecutive 12-month period (by issuing the securities, granting an option to purchase them, or receiving a participant's election to defer their receipt). The limit is the greatest of: (a) $1,000,000; (b) 15% of the total assets of the issuer (or of its parent if the issuer is a 100% subsidiary and the parent guarantees its obligations respecting the securities); or (c) 15% of the outstanding securities of the relevant class. The amount of outstanding derivative securities underlying currently exercisable or convertible options, warrants or other rights is calculated on a fully diluted basis. The 15% tests are applied as of the most recent balance sheet date of the issuer (or its parent) that falls on or after the last fiscal year end.

The "aggregate sales price" is the sum of all cash and all non-cash consideration received or to be received by the issuer. Non-cash consideration is valued with reference either to bona fide sales made within a reasonably contemporaneous time period or to an accepted fair value standard. Services are deemed equal in value to the securities issued for them. Options are deemed equal in value to the exercise

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[3] Rule 701(a) Interpretation www.sec.gov/regulatoryactions/interpretivereleases/December 21, 1995.

price on the grant date. Other securities are valued as of the sale date except that deferred compensation securities are valued as of the date an irrevocable election to defer is made by the participant.

The size limits applied under Rule 701 do not affect (are not subtracted from) the $5,000,000 limit imposed on the aggregate amount of securities offered under other Section 3(b) exemptions, such as the exemption provided by Rule 505 of Regulation D.

Required Disclosure

In any offering there must be disclosure at least sufficient to satisfy the basic anti-fraud and civil liability provisions that underlie all securities laws. While the SEC has acknowledged that employees may be in a better position to evaluate the companies that employ them than outsiders, a prudent issuer will furnish disclosure appropriate for a "reasonable" investor with whom it has no prior relationship. Special attention should be paid to the risks inherent in private company investments and to any adverse changes in the circumstances of the issuer that may not be apparent to persons outside of the management team.

The disclosure for an Employee Benefit Plan must be furnished a reasonable time before an option under the Plan must be exercised or an irrevocable decision under the Plan to defer compensation must be made. Rule 701 requires that a copy of the Plan or contract be delivered to participants in all cases. In addition, if the aggregate sales price in any 12-consecutive month period exceeds $5,000,000, the issuer must furnish (a) if the Plan is subject to ERISA, the "summary plan description" required by that statute; (b) if the Plan a is not subject to ERISA a summary of its material terms; (c) a description of applicable risks; and (d) the financial statements required by part F/S of Form 1-A (for Regulation A offerings) as of a date no more than 180 days before the sale of the securities. In general, these financial statements consist of a balance sheet, plus statements for the past two fiscal years of income, cash flows and stockholders' equity. Issuers must also furnish financial statements for acquired businesses and pro forma statements showing the impact of any "significant business combination" which has occurred or is probable.

All financial statements must conform to generally accepted accounting principles ("GAAP") applicable in the United States. Foreign issuers must furnish reconciliation to US GAAP. If the issuer has audited statements, the statements furnished to participants must also be audited. Otherwise, unaudited statements may be furnished. If the issuer uses its parent's total assets to determine the aggregate amount of securities to be sold, the parent's financial statements must be furnished.

Resale Limitations

Rule 701 exempts transactions; not securities. Accordingly, securities acquired in accordance with the Rule are "restricted" and may not be resold without registration or an exemption. The subject is beyond the scope of this Bulletin. By way of summary only, while the issuer is private, resale transactions should be examined on a case-by-case basis to establish that the reselling holder did not purchase the securities with the intent to distribute them and thus is not a statutory underwriter. Holders who have retained the securities for at least one year after paying for them may be able to resell safely under a series of SEC no-action letters creating an informal "4(1½)" exemption. The term applies where the resale transaction resembles both a routine secondary trade exempted by Section 4(1) and an issuer's private offering exempted by Section 4(2). After the issuer has been public for at least 90 days, a holder who has retained the securities for at least one year after paying for them, and is not an affiliate, may be able to resell freely under SEC Rule 144. Affiliates may be able to resell limited amounts of the securities in qualified broker's transactions under the same Rule.

State Exemptions

In General

Rule 701 securities are not "covered" by Section 18 of the Securities Act, which exempts certain offerings from state regulation. Accordingly, Rule 701 issuers must either register or find an exemption at the state level. State jurisdiction will clearly be implicated if the issuer is domiciled within the state, or any participant is a resident of the state. Moreover, if offers to participate in a compensatory plan are made or accepted within its boundaries, a state may assert jurisdiction even though the issuer is domiciled out of state and all persons who actually participate are out-of-state residents.

The statutes in states that have jurisdiction must be examined separately because they will not be uniform in their treatment of these plans. Many states have "blanket" transactional exemptions for offerings meeting Internal Revenue Code requirements for employee pension, profit-sharing or stock bonus plans (section 401); employee incentive stock options (section 422); or employee stock purchase plans (section 423). States may also exempt plans that do not meet Code requirements, but survive an advance review by the state securities administrator. Non-Code plans that are truly compensatory in nature and are offered only to directors, officers, employees and their families will usually pass muster. Plans used to raise capital or reward third parties who are independent of the issuer will not, though it is worth noting that another exemption for such plans may be available. Still other states have express statutory exemptions only for plans that are not defined with reference to the Code, but nevertheless may exempt non-Code plans informally or by granting no-action relief.

Significantly, plans may qualify for a Rule 506 exemption if they are limited to participants who qualify as "accredited investors," such as directors and officers of the issuer or affluent consultants or advisers, plus no more than 35 non-accredited participants. The advantages here are the absence of any dollar limit on the amount of securities offered and the fact that Rule 506 securities are "covered" by Section 18 of the Securities Act, while Rule 701 securities are not. Accordingly, state regulation of plans offered under Rule 506 is preempted, except for a short-form notice requirement and a modest filing fee.[4]

The Washington Exemption

Washington exempts the *securities* issued "in connection with" stock purchase, savings, pension, profit sharing etc. plans; not the *transactions* in which the securities are offered and sold. To be exempt, a plan must either satisfy the sections of the Internal Revenue Code cited above or be submitted to Washington's Department of Financial Institutions ("DFI") 30 days before the securities are offered. No express disclosure is required, but Washington's general anti-fraud and civil liability provisions will apply.[5]

The Washington exemption is not clarified by meaningful interpretative guidance. We know that participants eligible under the Internal Revenue Code are eligible in Washington. We can infer that advance submission to DFI of non-Code plans is required to ensure that the plans provide bona fide compensation to appropriate persons. However, because Washington exempts the securities, rather than the transaction in which they were issued, it is not clear whether *resales* are restricted. Policy considerations support restriction since unfettered resales can be equivalent to an unregistered public offering. Nevertheless, the plain words of the statute state otherwise. After a transaction is complete, any exemption afforded to it necessarily expires, but an exempt security is exempt for all time.

For a Washington issuer offering securities to employees across state lines, the resale question is moot. Federal law is implicated and the issuer must find a transactional exemption under Sections 3(b) or 4 of the Securities Act as well as exemptions in the other relevant states. Any such exemptions would result in "restricted securities" that could not be resold by the holder without registration or an exemption.

For a Washington issuer offering exclusively to employees resident in Washington, however, the resale question takes a different turn. This issuer will qualify for the federal exemption provided by Section 3(a)(11) of the Securities Act because its securities are "offered and sold only to persons resident within a single state…" On the face of it, the issuer would also qualify for the Washington exemption if its plan complied (or was plausibly consistent) with the Internal Revenue Code. As a result, the securities could

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[4] See, Hutchins-law.com/Publications, Essays - *"Private Placements, Parts I-IV"* and Bulletins - September 2010, *"Revised Net Worth Requirement for Accredited Investors."*

[5] See, respectively, RCW 21.20.310(10); 21.20.010 and 21.20.430.

be resold indefinitely in Washington without registration. When I enquired about this, I was told informally that DFI "interprets" the Washington statute to exempt only qualified *transactions* in which compensatory securities are originally issued; not resales. That is a remarkable tour de force given the statute's express exemption of the securities, but necessary if the universal legislative intent to confine plan exemptions to the issuer is to be given effect. Accordingly, resale restrictions do apply in Washington, but as a matter of lore; not law.

Additional Observations

Internal Revenue Code Plans v. Rule 701 Plans

As noted, issuers offering Code plans would have both a federal exemption under Rule 701 and a blanket statutory exemption in many states, including Washington. No filing with securities regulators need be made to claim these exemptions. A copy of the plan or contract document must always be furnished to participants under Rule 701. If less than $5,000,000 in securities is "sold" during any 12-consecutive month period, Rule 701 issuers would furnish any additional disclosure under the anti-fraud provisions and the facts disclosed would vary with the circumstances. If more than $5,000,000 is "sold," such issuers must furnish the disclosure discussed on page 3 under the caption "Required Disclosure."

However, the Internal Revenue Code provides tax benefits for plans that cover common law "employees." That means the issuer must have the right to *control* the manner in which participants provide services. Accordingly, independent consultants or advisers may be ineligible to participate in Code plans. Moreover, the Code's emphasis is on "rank and file" employees. Senior executives may be ineligible as "highly compensated" employees and advisers may be "disqualified persons" if they provide services to an ERISA plan. Rule 701, by contrast, covers all independent consultants or advisers so long as their services to the issuer or its affiliates are bona fide and are not provided in a capital raising transaction or to make a market in the issuer's securities. Moreover, the Rule does not limit compensation.

Protecting Confidential Information

Rule 701 issuers are, by definition, private companies. Many are reluctant to disclose financial information, intellectual property or other confidential matter when offering Employee Benefit Plans for fear that the information may reach competitors. Staying below the $5,000,000 threshold will avoid mandatory line-item disclosure under the Rule, but information that is materially adverse must be disclosed in any offering to avoid fraud claims. Requiring participants to sign confidentiality agreements can be effective and participants are no more likely to disregard such agreements than equity investors. In the final analysis, though, the risk of unauthorized disclosure of information is always present.

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