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SEC Liberalizes Rules for Private Company Equity Compensation

Equity compensation (including options to purchase stock or LLC units, restricted stock or units, and sales of equity to employees) is frequently used by publicly traded and privately held businesses to recruit and retain employees, directors, and other service providers. Businesses using these compensation techniques or equity-based nonqualified compensation deferral programs need to be concerned about compliance with federal and state securities laws for these programs.

For companies not subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934 (generally, non-publicly traded companies), Rule 701 under the Securities Act of 1933 (the “Securities Act”) provides an exemption from the registration requirements for offers and sales of securities under certain compensatory benefit plans or written agreements relating to compensation. The exemption covers securities offered and sold by a business under a plan or agreement with the business’ current employees, officers, directors, and certain other service providers. The maximum number of shares that may be sold under the Rule 701 exemption by a business in any 12-month period is the greatest of (a) shares valued at \$1 million, (b) shares equal in value to 15% of the business’ total assets or (c) 15% of the business’ issued equity shares or units.

Rule 701 requires, at minimum, that the individual receiving equity compensation (the “investor”) receive a copy of the written benefit plan. Additional disclosures are required when the exemption is to be used for more than a threshold amount of securities in any 12-month period. If the threshold is exceeded, the business must, within a reasonable period of time before the date of the “sale” (the date of the award or contractual commitment to the investor for the compensation or sale), deliver to investors a summary of the material terms of the plan (or, if the plan is covered by ERISA, the Summary Plan Description); the risk factors associated with the investment; and copies of the business’ (and possibly the parent

company's) financial statements.

The threshold for providing additional disclosures to investors had been \$5 million for almost 20 years but was changed to \$10 million, effective July 23, 2018. The disclosure threshold was increased by the Securities Exchange Commission (SEC) after a mandate to do so under the Economic Growth, Regulatory Relief, and Consumer Protection Act, which also requires the SEC to further revise this amount every five years in order to adjust for inflation.

With the doubling of the disclosure threshold, fewer businesses will need to make the additional disclosures, which will make it less expensive for companies to compensate their employees with the business' stock, while reducing risks associated with disclosing otherwise confidential financial information about the business. The higher limit also reduces the risk of non-compliance that can occur when the business exceeds the threshold and the disclosure has not been given for compensatory equity or nonqualified compensation over the prior 12 months. Once the threshold is exceeded, if disclosures have not been made for all compensatory equity or deferred compensation relying on Rule 701 in the past 12 months, the Rule 701 exemption is not available for any of the equity or deferred compensation.

Businesses can use the new disclosure threshold amount immediately, as long as the former \$5-million threshold was not exceeded. As of July 22, 2018, the \$10-million threshold will apply to exempt current offerings without additional disclosure up to that new threshold.

In addition to compliance with federal Rule 701, businesses must comply with varying state securities law compliance programs for their equity compensation and nonqualified compensation deferral programs. While many states have securities registration exemptions that apply if the requirements of Rule 701 are met, it is important for businesses to review and comply with the "blue sky" laws of the state in which each investor resides.

At the same time the amendment to Rule 701 was issued, the SEC also issued Release No. 33-10521, requesting public comments on various other issues relating to Rule 701 in an effort to update the

rule due to developments since the SEC last substantively revised it in 1999. The SEC seeks to (1) determine whether an increase or removal of the annual regulatory ceiling for Rule 701 transactions is appropriate; (2) better understand employee and service provider relationships and whether the current Rule 701 exemption does or should cover these arrangements; (3) obtain feedback on the timing and content of the heightened disclosures; and (4) gain insight into how certain derivative compensatory arrangements are structured and how best to address them under Rule 701. Comments regarding the concept release are due by September 24, 2018.

For more information, please contact [Patricia Plavko](#), [Alison Stemler](#), [James Giesel](#) or any attorney in Frost Brown Todd's [Employee Benefits Group](#) or [Corporate/Business Group](#).

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