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SECURITIES OFFERINGS TO EMPLOYEES, CONSULTANTS AND ADVISORS UNDER RULE 701

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SECURITIES OFFERINGS TO EMPLOYEES, CONSULTANTS AND ADVISORS UNDER RULE 701

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I. The Exemption

Rule 701, adopted pursuant to Section 3(b) of the Securities Act of 1933, as amended (the "Securities Act"),[1] provides an exemption from the registration requirements of the Securities Act for certain offers and sales of securities made pursuant to the terms of compensatory benefit plans or written contracts relating to compensation by an issuer that is not subject to the reporting requirements of Section 13 or Section 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and is not an investment company registered or required to be registered under the Investment Company Act of 1940.

II. Preliminary Notes

1. Rule 701 relates only to the registration requirements of the Securities Act. The antifraud provisions of the federal securities laws may require that disclosure be made to purchasers of securities despite the fact that Rule 701 dictates no specific disclosure requirements.

2. Rule 701 is not an exemption from applicable state securities laws.

3. Attempted compliance with Rule 701 does not constitute an exclusive election.

4. Only issuers may avail themselves of the Rule 701 exemption; the exemption is not available for resales.

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[1] Section 3(b) of the Securities Act grants the Securities and Exchange Commission (the "SEC") the authority to adopt special exemptions from the registration requirements of the Securities Act for issues of securities in which the aggregate amount offered to the public does not exceed $5,000,000. In 1988, the SEC adopted Rule 701, temporary Rules 702 and 703 and Form 701 pursuant to this authority. (SEC Release No. 33-6768 (April 14, 1988) (the "Release")). In October 1996, Congress enacted the National Securities Markets Improvement Act of 1996 ("NSMIA"), which gave the SEC the authority to provide exemptive relief in excess of $5 million for transactions such as offers to employees. The legislative history of NSMIA stated specifically that the SEC should use this new authority to lift the $5 million ceiling on Rule 701. Rule 701 was amended to lift the $5 million ceiling in Release No. 33-7645 (eff. April 7, 1999).

5. Because the purpose of Rule 701 is to facilitate the use of securities for compensation, the rule does not exempt offers and sales for other purposes, such as raising capital.

6. Securities issued pursuant to plans and schemes designed to evade the registration requirements of the Securities Act, although in technical compliance with Rule 701, are required to be registered.

III. Non-Public Issuers

Rule 701 may be used only by an issuer that is not subject to the reporting requirements of Section 13 or Section 15(d) of the Exchange Act, and is not an investment company registered or required to be registered under the Investment Company Act of 1940.

1. If an issuer which is currently a reporting company properly suspends or eliminates its reporting obligations under the Exchange Act, either pursuant to a statutory provision or a SEC rule, it may thereafter rely on the exemption provided by Rule 701 if the issuer satisfies the necessary conditions set forth below. New City Communications, Inc. (available Oct. 6, 1988).[2]

2. Options under a compensatory benefit plan, issued in reliance on Rule 701, whether vested or unvested on the date the issuer becomes subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act, may be exercised pursuant to Rule 701(a) even after the issuer becomes subject to the reporting requirement of Section 13 or 15(d) of the Exchange Act.[3] If, however, an issuer that is not subject to Exchange Act reporting and that has granted stock options under Rule 701 is acquired by a reporting issuer that seeks to assume the stock options and permit their exercise into the acquirer's shares, the exercise of the options is not exempted by Rule 701. (C&DI 271.04 (January 26, 2009)).

3. A foreign bank, which is subject to banking regulation in the United States and which engages only in traditional banking activities such as accepting

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[2] In *The Peoria Journal Star, Inc.* (available Oct. 6, 1988), a previous registration of interests in an employee stock ownership plan meant that the plan had periodic filing obligations under Section 15(d) of the Exchange Act. The plan sought a no-action letter from the SEC allowing the plan to de-register the interests and terminate the plan's periodic filing obligations. The plan argued that, had Rule 701 existed at the time of filing, the plan would never have filed the registration statement. The SEC rejected the preceding requirement and refused to allow a de-registration of the interests, holding that the plan could not "autonomously discontinue its filing obligations under Section 15(d) of the Exchange Act."

[3] Rule 701(a) Interpretation (available December 21, 1995).

deposits, will not qualify, for purposes of Rule 701, as an "investment company registered or required to be registered under the Investment Company Act of 1940" solely by virtue of the fact that it is making a compensatory offering of its securities to employees. This is true whether the securities are offered directly to the foreign bank's employees (Union Bank of Finland, Ltd. (available March 14, 1990)), through a stock purchase plan (Total (available January 26, 1996) and Essilor of America, Inc. (available April 3, 1997)), or through an employee benefit plan (Canadian Imperial Bank of Commerce (available January 18, 1989)).

4. A foreign issuer that submits home country reports pursuant to Rule 12g3-2 may rely on Rule 701. SEC Release 33-6768, n.3; Nissan Motor Corporation (April 22, 1994, 1994 SEC No-Act. LEXIS 453). Furthermore, the staff has permitted a U.S. subsidiary of a foreign private issuer whose ADRs were publicly traded on NASDAQ, but which had no class of securities registered under the 1934 Act, to offer ADRs to U.S. employees participating in the subsidiary's 401(k) plan, even though the ADRs to be offered were to be acquired in secondary open market transactions or from the accounts of other participants in the 401(k) plan, none of whom were affiliates of the issuer. Nissan Motor Corporation (April 22, 1994, 1994 SEC No-Act. LEXIS 453).

5. Where an issuer issued incentive stock options to its employees pursuant to Rule 701, which options could not be exercised until the issuer went public, the issuer was not required to take the number of holders of the options into account in determining whether it must register under Section 12(g) of the Exchange Act. Mitchell Int'l Holdings, Inc. (available December 27, 2000); Superior Services, Inc. (March 18, 1994, 1994 SEC No-Act. LEXIS 374). The new amendments do not count offers for purposes of calculating the available exempted amount, but do require issuers to count as sales the securities underlying the options at the time of the option based upon the exercise price. The SEC's Division of Corporation Finance revised the standards under which relief from the requirements of Section 12(g) will be granted to employee stock option plans offered pursuant to Rule 701.[4] Relief may be obtained if options are immediately exercisable, but holders of options must receive information equivalent to what would be contained in a registration statement and periodic reports under the Exchange Act. See, e.g., AMIS Holdings, Inc. (July 30, 2001); UTI Corp. (December 7, 2001).

6. A company that files Exchange Act reports on a voluntary basis, or in accordance with a contractual obligation, is eligible to use Rule 701. (C&DI Question 271.02 (January 26, 2009)).

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[4] Division of Corporation Finance, Current Issues and Rulemaking Project Quarterly Update (March 31, 2001).

IV. Conditions To Be Met

Rule 701 lists several conditions which must be met if offers and sales of securities are to be exempt from the registration requirements of the Securities Act.

A. Written Compensatory Benefit Plan or Contract

Exempt offers and sales of an issuer's securities under Rule 701 must be made pursuant to either a written compensatory benefit plan or a written contract relating to compensation established by the issuer or its parents or majority-owned subsidiaries.

1. Rule 701(c)(2) defines a "compensatory benefit plan" as "any purchase, savings, option, bonus, stock appreciation, profit-sharing, thrift, incentive, pension or similar plan."

    a. Neither the Release nor any interpretive letter by the SEC has added much gloss to this definition.

    b. The Release states, however, that the definition of "compensatory benefit plan" contained in Rule 701 was patterned on Rule 405, undoubtedly on the definition of "employee benefit plan" contained therein. The SEC emphasized in the Release that Rule 701 is to be used for compensatory purposes and specifically added a preliminary note to make that emphasis clear.

    c. The SEC has stated that the issuer and its counsel are in the best position to determine whether a particular plan constitutes a compensatory arrangement or a capital-raising device; *See* SCI Financial Group, Inc. (available Nov. 14, 1988), and that the SEC will not issue "no-action" letters with respect to whether a particular plan constitutes a compensatory arrangement under Rule 701. See, e.g., Sentinel Groups, Inc. (available Nov. 14, 1988).

    d. The SEC did, however, comment in SCI Financial Group, Inc. that the features of an employee stock ownership plan which:

        (i) placed limitations on the number and types of employee participants,

        (ii) provided financial assistance to employees for the purchase of stock through direct loans or loan guarantees by the issuer, and

(iii) established stock purchase prices on the basis of previous recent sales of the stock of the non-public issuer,

would not in and of themselves cause a compensatory plan to be deemed a capital-raising device.

e. The Release states specifically that interests in compensatory benefit plans that would be separate securities from the issuer's securities are also exempted from registration under the Securities Act by virtue of Rule 701.

f. An offer to employees to convert their participations in a profit sharing plan into interests in a newly established employee stock ownership plan ("ESOP") may qualify for Rule 701. Appleton Papers, Inc. (available July 3, 2001); Professional Food-Service Management, Inc. (available February 1, 1989, Fed. Secs. L. Rep. (CCH) 78,968). In addition, offers to sell interests in an ESOP in accordance with a particular employee's 401(k) contributions may also qualify for Rule 701. Appleton Papers, Inc. (available July 3, 2001); Willdan Associates (available July 28, 1993, 1993 SEC No-Act. LEXIS 877).

g. Rule 701 is available for the sale by a foreign company's Employee Share Trust (the "EST") of that company's securities to the 401(k) plan of the company's U.S. subsidiary, as the 401(k) participants may elect. Marshalls Finance Limited (available November 27, 1990). Rule 701 also is available for sales of the foreign issuer's shares by the EST directly to U.S. employees. Marshalls Finance Limited and Lasser Marshall, Inc. (available June 15, 1993, 1993 WL 218173).

h. Rule 701 was available for exchanges by a trust established by the issuer's foreign parent to exchange shares of the issuer's stock issued pursuant to stock options for shares of the stock of the issuer's foreign parent. The staff of the SEC specified that relief was granted because of the integral part that the exchange feature played in the compensatory benefit plan. Neopost S.A. (available February 14, 2001).

2. The compensatory benefit plan must be established by the issuer of the securities, by parents of the issuer, by majority-owned subsidiaries of the

issuer, by private subsidiaries of the issuer,[5] or by majority-owned subsidiaries of the issuer's parent.

a. The SEC staff has interpreted the term "majority-owned subsidiary" to include:

(1) a limited partnership in which the issuer is the sole managing general partner, owns over 50% of the total interests, and is a control person of the partnership, and

(2) a limited partnership in which the issuer is the sole managing general partner and owns less than a majority interest in the partnership, provided that under generally accepted accounting principles the issuer consolidates the limited partnership in its financial statements due to reasons of control. Sutter Surgery Centers, Inc. (available November 10, 1993, 1993 WL 467398).

b. Where, following a corporate acquisition, the acquired company's employee stock option plan is assumed by its new (publicly registered) parent and the options are converted into options to acquire stock of the parent, the offers and sales may not be made by the parent pursuant to Rule 701. C&DI Question 271.04 (January 26, 2009). Note that this C&DI supersedes Devon Energy Corporation (available May 12, 1989, Fed. Sec. L. Rep. (CCH) 79,304), which held that the options would continue to be governed by Rule 701.

3. Each participant in a compensatory benefit plan must be provided with a copy of the plan, or each party to a contract relating to compensation must be provided with a copy of the written contract.

a. The SEC has stated that although the written documentation "ought" to be provided to participants prior to the offer of securities, such documentation "must" be provided to such persons prior to the sale of securities. Jackson, Tufts, Cole & Black (available May 25, 1988). Thus, where stock purchase warrants were issued to non-employee advisors and consultants at a time when there was no written contract relating to compensation, and the company proposed to enter into written agreements with the warrant holders prior to the exercise of the warrants

[5] *See* Occidental Petroleum Corporation (August 3, 1999, 1999 SEC No-Act. LEXIS 667).

memorializing the terms under which the warrants were issued, the agreements satisfied the requirement of paragraph (b)(1)(ii) of Rule 701 with respect to any shares issued upon exercise of warrants after such agreements have been executed and delivered. Praxis Biologies, Inc. (available May 12, 1989, Fed. Sec. L. Rep. (CCH) 79,302).

b. The requirement for delivery of the written compensatory benefit plan may be satisfied for plans subject to the reporting and disclosure requirements of Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), by:

(i) the delivery to each participant in the plan of a copy of the summary plan description and summaries of material modifications required by ERISA, and

(ii) making a copy of the complete plan available for inspection and copying. Subcommittee on Employee Benefits and Executive Compensation (available Sept. 6, 1988).

c. Enhanced disclosure for sales above $5 million. As discussed below, the SEC adopted amendments to Rule 701 in 1999 (the "1999 Amendments") that require issuers who exceed $5 million in aggregate sales or amount of securities sold during any consecutive 12-month period to provide each purchaser with specified enhanced disclosures.

B. Eligible Offerees and Purchasers

The persons to whom offers and sales of securities may be made pursuant to the Rule 701 exemption include employees;[6] directors; general partners; trustees, where the issuer is a business trust; officers; and consultants and advisors, provided that such consultants and advisors render bona fide services and that such services are not in connection with the offer and sale of securities in a capital-raising transaction.

In the 1999 Amendments to Rule 701, the SEC added the requirements that a consultant or advisor be a natural person who has contracted directly with the issuer and who receives the securities directly from the issuer.[7]

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[6] In addition, sales to employees of majority-owned subsidiaries of the issuer's parent qualify for the Rule 701 exemption. *See* SEC Release No. 33-7645 (February 25, 1999), SEC LEXIS 406.

[7] SEC Release No. 33-7646 (February 25, 1999), 1999 SEC LEXIS 404.

1. Consultants and Advisors

a. The SEC staff has, through various interpretive letters, brought within the term "consultants and advisors" many categories of independent agents, franchisees and salespersons who did not have an employment relationship with the issuer.

b. The breadth of interpretation under Rule 701 gave rise to questions whether the range of eligible offerees under Rule 701 should be broader than those to whom securities may be offered on Form S-8. While offers to "consultants and advisors" also may be made pursuant to a registration statement on Form S-8, the terms are limited for this purpose to situations where "there is a de facto employment relationship between the person and the company." SEC Release No. 33-7506 (February 17, 1998), 1998 SEC LEXIS 256. In order to combat the improper use of Form S-8 by companies to compensate consultants whose services consisted of the promotion of their stock, the SEC adopted amendments to Form S-8 in February 1999 which "clarify that Form S-8 is not available for consultants and advisors who directly or indirectly promote or maintain a market for the issuer's securities" or who serve as conduits for distributing securities to the general public. SEC Release No. 33-7646 (February 25, 1999), 1999 SEC LEXIS 404. On the same day the SEC amended Form S-8, the SEC amended Rule 701 to change the definition of "consultants and advisors" in order to "harmonize the definition of 'consultants and advisors' permitted to use the exemption to the narrower definition of Form S-8." SEC Release No. 33-7645 (February 25, 1999), 1999 SEC LEXIS 406.

c. The SEC's release adopting the 1999 amendments to Rule 701 specifically overturned a number of the earlier letters,[8] stating that:

[8] The SEC overturned, for example, letters that had treated as "consultants or advisors" physicians under contract to provide services to the issuer's enrollees (The Morgan Health Group, Inc. (available April 9, 1996)), physicians employed by medical practices managed by the issuer (PHM Management, Inc. (available September 16, 1997) and Talbert Medical Management Corporation (available September 16, 1997)), and independent physicians under contract with the issuer to offer services to managed care organizations (Princeton Medical Management Resources, Inc. (available September 12, 1997)).

(1) "Independent agents, franchisees and salespersons who do not have an employment contract with the issuer no longer will be within the scope of 'consultant or advisor.' 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. Other persons displaying significant characteristics of 'employment,' such as the professional advisor providing bookkeeping services, computer programming advice, or other valuable professional services may qualify as eligible consultants or advisors . . .. Our staff will continue to handle questions about 'consultant or advisor' status on a case-by-case basis . . ., but the terms will be interpreted in the same manner for both Rule 701 and Form S-8."[9]

(2) The staff has interpreted this language to categorize as "de facto" employees independent sales representatives or distributors (either individually employed or working as employees of corporate sales representatives or distributors) that were exclusive agents of the issuer, had signed agreements with non-competition provisions and had represented that:

> (i) promotion of the issuer's products was the representative's or distributor's primary trade or business activity, and
>
> (ii) during the previous calendar year the representative or distributor derived, and for the next calendar year the representative or distributor expected to derive, the majority of his or her earned income from promotion of sales of the issuer's products. Herff Jones, Inc. (available March 13, 2000, reconsidered August 1, 2000), Wright Acquisition Holdings, Inc. (available August 2, 2000). Independent registered

[9] 1999 SEC LEXIS 406, at n. 37.

representatives of a broker-dealer were found to be de facto employees in LPL Holdings, Inc. (available April 18, 2001).

d. In the 1999 amendments the SEC made clear that the definition of "consultants and advisors" would no longer extend, as it had in the past, to golf professionals who offered the issuer's products through their pro shops, to non-employee sales agents and non-employee franchisees.[10]

2. Inclusion of Ineligible Participants

a. The participation in a compensatory benefit plan of persons other than those specifically listed above does not render the plan ineligible for the Rule 701 exemption.

b. If a plan provides for the participation of listed persons and non-listed persons, offers and sales of securities to listed persons may properly be made in reliance on Rule 701.

c. Offers and sales of securities to non-listed persons must be made pursuant to either registration under the Securities Act or an appropriate exemption from registration other than that provided by Rule 701. Watson, Ess, Marshall & Enggas (available June 24, 1988).

3. Former Employees

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[10] Many categories of persons who had been eligible to participate in the Rule 701 exemption prior to the adoption of the 1999 Amendments are now excluded. Among those now excluded are golf professionals who offer the issuer's merchandise through their pro shops (Golfpro, Inc. (available October 3, 1989)), non-employee sales representatives who market the issuer's products in designated geographic areas, (Microchip Technology, Inc. (available November 4, 1992)), and non-employee franchisees that, in exchange for marketing, training and limited technical support from the franchisor, pay monthly royalty and advertising fees to the franchisor (USWeb Corporation (available November 7, 1996)).

The 1999 Amendments also overruled, by inference, the staff's earlier conclusion that non-employee insurance agents who receive options and bonus shares based on their performance in selling insurance policies of an affiliate of the issuer could be treated as consultants or advisors. (Exceptional Producers Holding Co. (available August 17, 1989)). Under the 1999 Amendments, only "insurance agents who are exclusive agents of the issuer, its subsidiaries or parents or who derive more than 50% of their annual income from the issuer [will] be considered 'employees'" for purposes of Rule 701 and Form S-8. SEC Release No. 33-7645 (February 25, 1999), 1999 SEC LEXIS 406.

a. A compensatory benefit plan may permit a former employee to exercise options after the termination of her employment, which options were initially granted and vested during the course of her employment. Sentinel Groups, Inc. (available Nov. 14, 1988).

b. In addition, under the 1999 Amendments, sales to former employees may be completed if those persons were employees when the securities were initially offered. SEC Release No. 33-7645 (February 25, 1999), 1999 SEC LEXIS 406.

C. Amount of Securities Permitted to be Offered and Sold

1. The amount of an issuer's securities that may be sold during any consecutive 12 month period in reliance upon Rule 701 may not exceed the greater of :

   a. $1,000,000 (the "$1 Million Ceiling" (which more properly should be called the "1 Million Floor");

   b. 15% of the issuer's total assets (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 (the "Assets Formula"); or

   c. 15% of the outstanding class of securities being offered, measured at the issuer's most recent balance sheet (the "Outstanding Securities Formula").[11]

2. Any amount of securities may be offered in reliance on Rule 701. However, for purposes of the rule, sales of securities underlying options must be counted as sales on the date of the option grant. Rule 701(d)(1). Thus, as a practical matter, the amount of offers that may be made through stock options is limited to the restrictions on the amount that may be sold.

3. If an issuer sells shares in excess of the Rule 701(d) limits, it loses the Rule 701 exemption for sales of shares that exceed the Rule 701(d) limits. Rule 701(f) provides, however, that sales under Rule 701 are not subject to integration with other sales that are otherwise exempt from the registration requirements of the Securities Act. Therefore, an issuer may rely on an available alternative exemption such as a limited offering exemption under

[11] SEC Release No. 33-7645 (February 25, 1999), 1999 SEC LEXIS 406.

Rule 504 of Regulation D or a private placement exemption under Rule 506 of Regulation D or Section 4(2) for the sales in excess of the Rule 701(d) limits, and rely on Rule 701 for sales that do not exceed the Rule 701(d) limits. (C&DI Question 271.07 (Jan. 26, 2009)).

4. As is further discussed below, if the aggregate sales price or amount of securities sold during any consecutive 12-month period exceeds $5 million, the issuer must provide the disclosure required by Rule 701(e) a reasonable period of time before the date of sale.

5. The term "aggregate sales price" means the sum of all cash, property, notes, cancellation of debt or other consideration received or to be received by the company for the sale of the securities. Non-cash consideration must be valued by reference to bona fide sales of that consideration made within a reasonable time or, in the absence of such sales, on the fair value as determined by an accepted standard. The value of services exchanged for securities issued must be measured by reference to the value of the securities issued. Options must be valued based on the exercise price of the options. (Rule 701(d)(3)(i).)

6. The timing for calculating the price depends on the type of compensation awarded:

   a. For options to purchase securities (such as shares of common stock), the grant of the option is considered the issuance of the security, so options are counted as of their grant date and are valued at their exercise price (regardless of when the option becomes exercisable). Sales of securities underlying options must be counted as sales on the date of the grant of the option.

   b. For securities (such as shares of common stock), the calculation is made on the date of sale.

   c. For deferred compensation or similar plans, the calculation is made when the irrevocable election to defer is made. (Rule 701(d)(3)(ii).)

7. Rule 701(d)(3)(i) specifies that "all cash, property, notes, cancellation of indebtedness or other consideration to be received by the issuer for the issuance of the securities" should be included in calculating the aggregate sales price of securities issued in reliance upon Rule 701. Non-cash consideration must be valued in reference to bona fide sales of that consideration made within a reasonable time or, in the absence of such sales, on the fair market value of such consideration. The Release states specifically that services rendered by an employee as part of her regular employment would not be considered additional consideration. If

securities are issued to consultants or advisors as payment for their services, however, the value of the services rendered should be included in calculating the aggregate offering price.

8. Because Rule 701 is designed to cover only transactions pursuant to compensatory arrangements, aggregation principles applicable to Rule 701 consider only offerings under Rule 701. Moreover, the ceilings for other transactions made in reliance upon other exemptions adopted pursuant to Section 3(b) of the Securities Act are not affected by offers and sales made under Rule 701. *See* Rule 701(d)(3)(iv).

9. Rule 701(f) states specifically that all offers and sales exempted from registration pursuant to Rule 701 are deemed to be part of a single, discrete offering and are not subject to integration with any other offering by the issuer, whether registered under the Securities Act or otherwise exempt from the registration requirements.

    a. The Release notes, however, that because public offerings are permitted under Rule 701, a general solicitation issue may result if offering materials for a Rule 701 transaction are generally used and an issuer is relying upon some other exemption from registration for a limited offering involving the same or a similar compensation plan or arrangement.

    b. The SEC has stated that a valid exemption from registration under the Securities Act for previous offers and sales of securities, such as pursuant to Section 3(a)(11), Section 4(2) or Regulation D under the Securities Act, would be unaffected by subsequent offers and sales of securities made in purported reliance upon Rule 70l, even where those subsequent sales did not comply with Rule 701 and were without a valid exemption. Jackson, Tufts, Cole & Black (available May 25, 1988).

10. The $1 Million Ceiling.

    a. The $1 Million Ceiling under Rule 701 (which really should be referred to as the "$1 Million Floor") is calculated on a rolling 12-month basis and is available to the issuer despite the fact that it may be greater than the amounts calculated under either the Assets Formula or the Outstanding Securities Formula. *See* Subcommittee on Employee Benefits and Executive Compensation (available Sept. 6, 1988).

    b. Because the $1 Million Ceiling involves a retrospective and fixed amount, however, an issuer's failure to keep sales of

securities at or below $1,000,000 in a 12-month period would jeopardize the availability of the Rule 701 exemption for all offers and sales of securities during that period. Jackson, Tufts, Cole & Black (available May 25, 1988).

11. The Assets Formula and the Outstanding Securities Formula

a. Decreases in an issuer's total assets or outstanding securities will have no effect on outstanding sales properly made in a previous 12-month period in reliance upon a bona fide calculation under the Assets Formula or the Outstanding Securities Formula, respectively. Such transactions may be consummated regardless of future decreases in the issuer's total assets or outstanding securities. The issuer may not, however, sell any additional securities in reliance upon the outmoded calculation. Jackson, Tufts, Cole & Black (available May 25, 1988).

b. The SEC has implied, however, that if the issuer initially relies on one formula, the issuer may later change its reliance under Rule 701 to the other formula if the other formula provides a more advantageous calculation.

(1) Despite a decrease in an issuer's total assets or outstanding securities from a previous 12-month period, an issuer may make new offers and sell additional securities if a sufficient number of unexercised options expire and, as a result, the aggregate offering price of the securities subject to outstanding options becomes less than 15% of the issuer's total assets as of the end of its most recent fiscal year, or the number of securities subject to outstanding options becomes less than 15% of the outstanding securities of that class.

(2) Calculations under the Outstanding Securities Formula should include securities of the class in question which are issuable pursuant to the exercise of outstanding options, warrants or rights or the conversion of convertible securities, unless such options, warrants, rights or convertible securities were themselves issued under Rule 701. This calculation does not, however, include those securities which may be acquired upon the exercise of options, warrants or rights which are not presently exercisable, or upon the conversion of

convertible securities which are not presently convertible. Calculations under the Outstanding Securities Formula should never include securities issuable pursuant to Rule 701. Subcommittee on Employee Benefits and Executive Compensation (available Sept. 6, 1988).

(3) Three classes of shares, all with essentially the same rights and privileges, may be considered as a single class of securities for purposes of making this calculation. Deluxe Corporation, (August 6, 1998, Fed. Sec. L. Rep. (CCH) 77,461). *See also* Osler Health, Inc. (available February 11, 1998) (a company's Class A common stock, issued to founders and investors, and its Class B common stock, issued to certain physicians, may be considered a single class of securities for purposes of calculating under the prior version of Rule 701(b)(5)(iii), formerly known as Rule 701(b)(5)(ii), based on the representation that Class A common stock and Class B common stock would have equal rights and privileges, except that Class B common stock was non-voting, and if the company would do an IPO, Class B common stock would convert automatically into Class A common stock). *See also* Arclight Systems, LLC (available January 17, 2002) (the Company's "A Units", "B Units", and "C Units" may be considered as a single class for the purposes of calculating under Rule 701(d)(2)(iii) based on the Company's representation A, B and C Units are "virtually identical in all respects and have equal rights and privileges, with a few minor differences."

(4) Calculations under either formula may be based on the issuer's balance sheet at the end of the most recently completed fiscal year or a more recent balance sheet, at the option of the issuer. If the issuer's balance sheet for the most recent fiscal year end is not yet available, the issuer may use a prior balance sheet during the 90 days following fiscal year end, if:

(a) the balance sheet used is as of a date no more than three months before the end of the most recent fiscal year and

(b) (ii) the issuer prepares and uses a balance sheet for the most recent fiscal year end within 90 days following fiscal year end. American Bar Association (available December 7, 2000).

V. Disclosure Requirements

A. General Disclosure Requirements

1. Rule 701 transactions are not exempt from:

   a. Antifraud laws;

   b. Civil liability;

   c. Other provisions of the federal securities laws

2. Issuers have an obligation to provide Rule 701 transaction investors with "disclosure adequate to satisfy the antifraud provisions of the federal securities laws." Issuers who fail to do so risk enforcement action by the SEC.

   a. The best policy is to provide Rule 701 investors with a description of both the merits and the risks of making an investment in the issuer.

   b. Use a "reasonable investor" standard in deciding what information is necessary to be provided. I.e., what disclosure information would a reasonable investor expect to receive before making an investment in a non-public company?

   c. In the 1999 Amendments, the SEC stated:

      (1) "The type and amount of disclosure needed in a compensatory securities transaction differs from that needed in a capital-raising transaction."

      (2) "Because the compensated individual has some business relationship, perhaps extending over a long period of time, with the securities issuer, that person will have acquired some, and in many cases, a substantial amount of knowledge about the enterprise. The amount and type of disclosure required for this person is not the same as for the typical investor with no particular connection with the issuer."

(3) "The current standards of financial statement disclosure contained in Regulation A should satisfy our concerns for a level of disclosure that will provide basic protections in a compensatory transaction but may not be available as a result of ordinary employment or business dealings."

3. The issuer must deliver Rule 701 investors a copy of the compensatory benefit plan before the date of sale.

4. Unlike offerings under Rule 506 of Reg D, offerings under 701 are not exempted from state registration. Some states in which employees reside may require filings and advance clearances before offerings may be made to employees in those states.[12] In states in which no exemption is available, it may be possible to qualify the offers in those states under Rule 506, in which case the offerings in those states will be exempt from state registration, other than any required notice filings and fees.

B. Specific Disclosure Requirements for Sales Exceeding $5 million During Any Consecutive 12-month Period

1. If during any 12-month period, the issuer has aggregate sales exceeding $5 million, then the issuer must deliver, within a reasonable period of time prior to the date of sale, the following:

a. If the plan is subject to the Employee Retirement Income Security Act of 1974 ("ERISA"), a ***copy of the summary plan description*** required by ERISA, or, if the plan is not subject to ERISA, a ***summary of the material terms of the plan***;

b. ***Information about the risks associated with investment*** in the securities sold pursuant to the compensatory benefit plan or compensation contract; and

c. ***Financial statements*** required to be furnished by Part F/S of Form 1-A (Regulation A Offering Statement) under Regulation A.[13] (Financial statements required to be

[12] Many states have 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, either by statutory exemption or by exercise of discretion by the state securities administrator.

[13] Foreign private issuers as defined in §230.405 must provide a reconciliation to generally accepted accounting principles in the United States (U. S. GAAP) if their financial statements are not prepared in accordance with U. S. GAAP (Item 17 of Form 20-F).

furnished by Part F/S of Form 1-A under Regulation A. This would include statements of income, cash flow and stockholders' equity for the last two years plus any stub period since the end of the most recent fiscal year. It would also include a balance sheet as of the end of the most recent fiscal year and any stub period since that period. Foreign private issuers must provide a reconciliation to US generally accepted accounting) The financial statements required by this section must be dated no more than 180 days before the date of sale of the securities. Unaudited financial statements are acceptable, unless the issuer has audited financial statements, in which case such audited financial statements must be provided.[14]

(1) If the issuer is relying on paragraph (d)(2)(ii) of Rule 701 to use its parent's total assets to determine the amount of securities that may be sold, the parent's financial statements must be delivered.

(a) If the parent is subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, the financial statements of the parent required by Rule 10-01 of Regulation S-X and Item 310 of Regulation S-B, as applicable, must be delivered.

d. If the sale involves a stock option or other derivative security, the issuer must deliver disclosure a reasonable period of time before the date of exercise or conversion. For deferred compensation or similar plans, the issuer must deliver disclosure to investors a reasonable period of time before the date the irrevocable election to defer is made.

e. Retroactive loss of exemption. If sales in a Rule 701 offering exceed $5 million in a 12-month period, and the required information has not been provided to all investors before sale, the issuer will lose the exemption for the entire offering when sales exceed the $5 million threshold.[15] Because of the risk of retroactive loss of the exemption, issuers that face any risk of sales in excess of $5 million in a 12-month period should begin providing the increased disclosure prior to all sales. Further, issuers should be cautioned in the drafting of stock incentive plans to make

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14 Release No. 33-7645, at n. 22.

15 SEC Release No. 7645 (Feb. 25, 1999); C&DI Question 271.12.

sure that if the issuer faces the sale of more than $5 million in a 12-month period, it will be able to defer further exercises until 12-month sales are safely below $5 million.[16]

f. Efforts to raise the disclosure threshold. The Encouraging Employee Ownership Act (EEOA) of 2014 (H.R. 4571) was approved by the House Financial Services Committee on May 22, 2014, by a vote of 36–23. The EEOA would raise the Rule 701 threshold for providing heightened disclosures for compensatory stock programs from $5 million to $20 million, and would adjust it for inflation every five years.

C. Enforcement of Disclosure Requirements for Sales Exceeding $5 million During Any Consecutive 12-month Period

1. The disclosure requirements of Rule 701 were the subject of the SEC's first enforcement action under the rule. In the Matter of Google, Inc. and David C. Drummond,[17] was an action brought by the SEC against Google, Inc., a public company, and its General Counsel, David C. Drummond. Google and Drummond consented to the entry of an order that they cease and desist from any further violations of the registration requirements of the Securities Act.

2. Allegations of the complaint regarding Google:

   a. Google, prior to its initial public offering in 2004, issued over $80 million worth of stock options to the its employees and consultants from 2002 to 2004 without registering the offering and without providing required financial information required to such employees and consultants.

   b. Google thought that the public disclosure of its detailed financial information would be strategically

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16 Practice note: Note that if an issuer inadvertently has made sales that cause it to exceed the $5 million threshold without providing enhanced disclosure, it may be possible, by reviewing the sales that have taken place, retroactively to attribute exemptions other than Rule 701 to certain sales, thereby reducing the total sold under Rule 701.

17 SEC Release No. 8523 (January 13, 2005). David C. Drummond is Google's General Counsel. The SEC claims that Mr. Drummond "caused Google to violate" U.S. securities laws (specifically, the registration provisions of Section 5 of the Securities Act.

disadvantageous because it could end up in the hands of Google's competitors

c. The SEC believed that Google failed to monitor its stock option grant levels, and failed to determine whether it was complying with Rule 701.

3. Allegations regarding Drummond

a. David Drummond, Google's General Counsel, knew in June 2003 that Google would exceed the $5 million disclosure threshold of Rule 701 if the Board adopted two new stock option plans that allowed for the issuance of additional options;

b. Drummond believed that Google could not rely on Rule 506 because it was likely that there were not enough stock option recipients who qualified as accredited investors to make the securities exempt from registration; and

c. Drummond did not tell Google's Board of Directors that Google's option grants had exceeded the $5 million threshold or that there was a risk that exemptions from registration of such securities may not apply.

4. SEC Comments regarding Drummond

a. The Commission alleged in its Complaint that Drummond believed that even if his analysis of the registration exemptions was incorrect, Google could correct the situation with an offer of rescission to the option holders.

b. The SEC criticized Drummond's approach toward compliance with Rule 701 and with the Federal securities laws. Stephen M. Cutler, Director of the SEC's Enforcement Division stated: "Companies cannot freely decide that they don't need to comply with the law." Helane Morrison, District Administrator of the SEC's San Francisco District Office stated: "Attorneys who undertake action on behalf of their company are no less accountable than any other corporate officers. By deciding Google could escape its disclosure requirements, and failing to inform the Board of the legal risks of his determination,

Drummond caused the company to run afoul of the federal securities laws."[18]

D. Competing Interests – Offering Securities to Employees versus Confidentiality of Non-Public Financial Information

The SEC noted in the 1999 Amendments that "Some commenters expressed concern that requiring a private issuer to deliver disclosure documents, particularly financial statements, to employee-investors could result in serious harm to the company if the information were to come into possession of its competitors."

The SEC addressed this issue by stating: "In view of the substantial amounts of securities that may now be issued under Rule 701, we believe that a minimal level of disclosure consisting of risk factors and Regulation A unaudited financial statements is essential to meet even the lower level of information needed to inform compensatory-type investors such as employees and consultants." The SEC also noted that "Private issuers can use certain mechanisms, such as confidentiality agreements, to protect competitive information. Alternatively, an issuer could elect to stay below the $5 million threshold to avoid these disclosure obligations."

VI. Limitation On Resales

As noted above in the Preliminary Notes, Rule 701 is available only to issuers and is not available for resales. Resales of securities issued pursuant to Rule 701 must be made in compliance with the registration requirements of the Securities Act or an appropriate exemption therefrom.

A. Application of Rule 144

1. Although the Rule 701 exemption permits an issuer to make a public offering of its securities without registration under the Securities Act, Rule 701(g) states specifically that securities issued pursuant to Rule 701 are to be deemed "restricted securities" as defined in Rule 144 under the Securities Act. Rule 144 permits such securities to be resold if all of the terms of Rule 144, including the holding period, are complied with. It does not matter that the offering under Rule 701 may not have been a private placement.

2. Rule 701(g)(3) provides that 90 days after an issuer becomes subject to the reporting requirements of the Exchange Act, securities issued in a Rule 701 transaction may be resold pursuant to Rule 144 by a person who is not an affiliate of the issuer in reliance on Rule 144, without compliance with

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[18] "SEC Charges Google and Its General Counsel David C. Drummond with Failure to Register over $80 Million in Employee Stock Options Prior to IPO," SEC Press Release 2005-6 (January 13, 2005).

paragraphs (c), (d), (e) and (h) of Rule 144, and by affiliates without compliance with paragraph (d) of Rule 144.

3. The SEC has stated that the relief provided by Rule 701(g)(3) where an issuer becomes subject to the reporting requirements of the Exchange Act encompasses all facets of Rule 144(d), including the elimination of the requirement in Rule 144(d)(2)(iii) that promissory notes or installment contracts given in consideration of the securities be discharged by payment in full prior to the resale. Jackson, Tufts, Cole & Black (available May 25, 1988).

4. Where there is a private resale of shares issued pursuant to Rule 701, however, the application of the rule terminates. The purchaser is considered to have acquired restricted securities, and the relief provided by 701(g)(3) will no longer be available. Central Point Software, Inc. (available March 9, 1993). One recognized exception is transfer of Rule 701 shares to a spouse pursuant to a divorce; in that case, the spouse may resell under 701(c)(3). Trimble Navigation (available January 29, 1991, CCH Fed. Secs. L. Rptr. 79,702). In addition, shares may be resold under 701(c)(3) after having been transferred by the original purchaser to a revocable living trust. Allied Telesyn International Corp. (March 3, 1995).

VIII. JOBS Act Relief from Exchange Act Reporting

Section 501 of the Jumpstart Our Business Startups Act (JOBS Act) raised the threshold for mandatory registration under Section 12(g) of the Securities Exchange Act of 1934 from 500 to 2,000 shareholders of record (as long as the company does not have 500 shareholders of record who are not accredited investors, in which case the 500-shareholder limit effectively remains). Shareholders "of record" now exclude crowdfunding investors and persons who receive securities pursuant to employee compensation plans that are exempt from registration under the Securities Act (which is consistent with the SEC's no-action position permitting private companies to exclude holders of stock options when determining whether they have 500 holders). The 2,000-holder rule will give many private companies more control over whether and when they wish to become a public company and can forestall the associated time, expense and regulatory burden associated with becoming a public company.

Proposed Regulations Relating to 1934 Act Registration

On December 18, 2014, the Securities and Exchange Commission proposed new rules to implement the JOBS Act provisions relating to registration, termination of registration, and suspension of reporting under Section 12(g) of the 1934 Act. (The full text of the release may be found at http://www.sec.gov/rules/proposed/2014/33-9693.pdf.)

The JOBS Act directed the SEC to modify the definition of "held of record" under Exchange Act Section 12(g)(5) to exclude securities held by persons who received the securities in exempt transactions under an "employee compensation plan" and to create a safe harbor for issuers to follow when making that determination.

The SEC has proposed amending Exchange Act Rule 12g5-1 so that, in determining whether an issuer is required to register a class of equity securities with the Commission, securities "held of record" would not include securities held by persons who received such securities pursuant to an "employee compensation plan" in transactions exempt from the registration requirements of Section 5 of the Securities Act or that did not involve a sale within the meaning of Section 2(a)(3) of the Securities Act.

The definition of "employee compensation plan" would come by way of Rule 701(c), the SEC's exemption for securities issued until employee compensation plans. The safe harbor would exclude from "held of record" calculations any holders of securities received pursuant to "any purchase, savings, option, bonus, stock appreciation, profit sharing, thrift, incentive, deferred compensation, pension or similar plan" in a transaction that met the conditions of Rule 701(c). The safe harbor would apply as long as the conditions of Rule 701(c) are met, even if any conditions set forth in other portions of Rule 701, such as issuer eligibility, volume limitations or disclosure delivery provisions, are not met.

As proposed, the safe harbor would be available not only to employees, but to all plan participants described in Rule 701(c), which includes employees, directors, general partners, officers, and certain consultants and advisors and their family members who acquire such securities from such persons through gifts or domestic relations orders (but not, for purposes of the proposed rules, their assignees, who would have to be counted as record holders). The rule also exclude from the "held of record" count former employees or other eligible recipients, if such persons were employed by or providing services to the issuer at the time the securities were offered.

The proposed safe harbor is nonexclusive, so that failure to satisfy the conditions of Rule 701(c) would not preclude reliance on Section 12(g)(5) of the Exchange Act (which excludes from the definition of 'held of record' securities "held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of section 5 of the Securities Act of 1933") or other provisions of proposed Rule 12g5-1(a)(7).

The proposed rules would also permit the issuer to exclude securities held by persons (1) who are eligible to receive securities from the issuer pursuant to Securities Act Rule 701(c), and (2) who received the securities in an exempt transaction in exchange for compensatory securities that had been excludable from the determination of securities held of record. This exclusion for securities obtained in exchange transactions is intended to facilitate an issuer's ability to engage in restructurings, business combinations and similar transactions that are exempt from regulation under the Securities Act.

Determination of Holders Under Employee Compensation Plans.

Under the proposed rules, issuers with substantial holders of employee compensation securities will need to monitor ownership to keep track of when transfers of the securities are made to persons who must be counted as holders of record who would count against the 2,000 holder limit. There is likely to be a great deal of confusion in the administration of these rules, and a need to establish clear guidelines for corporate administrators.