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The SEC Increases Enhanced Disclosure Threshold Under Rule 701 and Considers Broader Changes

by Alison E. Wright & Natalie N. Wilson

Following the enactment of the Economic Growth, Regulatory Relief, and Consumer Protection Act, the Securities and Exchange Commission (SEC) has adopted an amendment to Rule 701(e) increasing the threshold amount of securities that can be sold during a 12-month period from $5 million to $10 million. Securities sold in excess of the threshold trigger enhanced disclosure obligations for the issuer. Additionally, the SEC has issued a concept release requesting public comments on the modernization of Rule 701 and Form S-8.

The Exemption Under Rule 701

Rule 701 provides an exemption from the registration requirements of the Securities Act of 1933, allowing private, non-reporting companies to issue equity to employees, directors, consultants and advisors for compensatory purposes, subject to certain requirements. The exemption under Rule 701 recognizes that equity compensation plays an important role in recruiting and retaining talent, as well as aligning company and employee goals and success. However, the exemption is subject to certain limits to ensure the protection of employees as investors.

The exemption is available to companies so long as the amount of securities sold in any 12-month period in reliance on Rule 701 does not exceed the greater of $1 million, 15% of the company's assets, or 15% of outstanding securities of the class being sold.

Enhanced Disclosure Requirements and Increased Threshold

Regardless of the number of securities sold in reliance on Rule 701, companies must provide all eligible recipients with a copy of the written compensation plan or contract covering the offering. Prior to the adoption of the amendment, if a company issued more than $5 million in securities in any 12-month period in reliance on Rule 701, enhanced disclosure requirements applied. The amendment increases the threshold for enhanced disclosure to $10 million dollars, and future increases will be made to adjust for inflation every 5 years, rounding to the nearest $1,000,000.

The enhanced disclosure requirements require companies to provide additional materials to eligible recipients, such as financial statements for the two most recent fiscal years (prepared in accordance with GAAP) and risk factors. Preparing and distributing such materials can be burdensome and costly for private companies, and as a result, companies carefully limit and monitor their offerings under Rule 701.

While the threshold amount for enhanced disclosure has increased, companies should also be mindful that the disclosure requirements themselves remain unchanged.

Potential for Further Changes

Concurrently with the adoption of the amendment to Rule 701(e), the SEC issued a concept release requesting public comment on other aspects of Rule 701 and Form S-8.

Overall, the concept release seeks comment on how to streamline the rules related to compensatory issuances of equity in response to an evolving "gig economy" and changing company-worker relationships. More specifically, the concept release asks whether eligibility should be extended to other types of employment relationships under Rule 701, whether disclosure content and timing under Rule 701(e) should be further revised, and whether offerings on Form S-8 should be further streamlined.

Hanson Bridgett's Employee Benefits and Corporate Group will be monitoring any further developments related to the concept release.

Recommended Actions

The increased enhanced disclosure threshold of $10 million, which applies to current offerings, should provide private, non-reporting companies with greater opportunities and flexibility to utilize equity based compensation for service providers. In addition, companies have an opportunity to provide comments to the SEC on the concept release. Companies should take this opportunity to review their plans with respect to equity compensation, as well as their compliance with applicable disclosure requirements.

Companies with questions regarding Rule 701 or the concept release are encouraged to contact the Hanson Bridgett Employee Benefits Group or Corporate Group.

For more information, please contact:

Alison E. Wright, Partner
415-995-5083
awright@hansonbridgett.com

Natalie N. Wilson, Senior Counsel
415-995-5157
nwilson@hansonbridgett.com