

Rule 701: How to Reward Employees and Consultants with Equity Compensation

Issuing equity to employees can be a win-win. For companies, such transactions preserve cash that might go to salary or wage payments and can align interests of labor and capital by making both sides interested in a company's long-term success. Companies can also conserve cash by using equity to pay outside service providers. Meanwhile, owning equity allows employees to share in a company's upside, potentially making them very wealthy if their company becomes the next unicorn. While stock options (made famous during the 1990s tech boom) may be the most well-known type of equity incentive, there are several other types of equity compensation, including shares of stock, restricted stock units and stock appreciation rights.

Whatever form employee equity takes, it is a security that must be registered under federal law and qualified under applicable state law, absent applicable exemptions. There are different regulatory schemes for private and public companies. By filing a shortened registration statement on Form S-8, public companies may issue securities to employees, directors, consultants, and advisers as part of an employee benefit plan, which can also include profit-sharing, bonuses, options, or other incentives.

Rule 701. Private companies, on the other hand, may take advantage of Rule 701 promulgated under the Securities Act of 1933. Rule 701 applies only in compensatory situations and may not be used for capital raising. Rule 701 is available to both U.S. domestic and foreign private issuers but is limited to issuers and may not be used for affiliates and other persons seeking to resell securities. Rule 701 transactions are subject to the antifraud provisions of the federal securities laws.

Eligibility. Rule 701 permits issuances to employees and other specified persons (such as directors and certain consultants and advisers) without federal registration provided that the securities are granted or issued pursuant to a written compensatory benefit plan, which can be an employment agreement. Rule 701 also permits sales to family members of employees who receive securities from eligible recipients through gifts or domestic relations orders. To receive securities under Rule 701, consultants and advisers must (i) be natural persons; (ii) provide bona fide services to the issuer or certain of its affiliates; and (iii) provide services that are not in connection with the offer or sale of securities in a capital-raising transaction, and do not promote or maintain a market for the issuer's securities.

Amount. The aggregate sales price or amount of securities sold under Rule 701 must not exceed the greatest of the following: (i) \$1 million; (ii) 15% of the total assets of the issuer, measured as of the date of the issuer's most recent balance sheet; or (iii) 15% of the outstanding amount of the class of securities being offered and sold in reliance on Rule 701, measured as of the date of the issuer's most recent balance sheet. These measures apply on an aggregate basis, not plan-by-plan. For securities underlying options, the aggregate sales price is determined when the option grant is made, regardless of when it becomes exercisable. For deferred compensation plans, the calculation is made at the time of the participant's irrevocable election to defer. There is no separate limitation on the number of securities that may be offered.

Disclosure. Rule 701 requires an issuer to provide a copy of the relevant compensatory plan to all eligible recipients a reasonable time prior to the sale of securities. For stock options, such disclosure must be delivered prior to the date of exercise, and for all other equity awards, the disclosure must be provided prior to the date of grant. If the aggregate sales price of securities sold in reliance on Rule 701 exceeds \$10 million in a 12-month period, then, in addition to providing recipients with a copy of the compensatory plan, the issuer must also provide additional enhanced disclosures to all eligible

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recipients, including: (i) a summary of the material terms of the compensatory plan or compensatory contract; (ii) risk factors; and (iii) financial statements for the two most-recently completed fiscal years of the issuer prepared in accordance with U.S. generally accepted accounting principles dated not more than 180 days before the sale. This requirement is retroactive so that the issuance of any securities in excess of the \$10 million threshold means that appropriate disclosure must be delivered to all recipients during the applicable twelve-month period, including recipients who were issued securities prior to the \$10 million threshold being crossed. As startups stay private longer and attain higher valuations, startups should take extra care to remain in compliance with Rule 701 disclosure requirements.

Transfer Restrictions. Securities issued pursuant to Rule 701 are “restricted securities” as defined under Securities Act Rule 144 and must be transferred in compliance with such Rule or another exemption from registration.

No Integration; Blue Sky Compliance. Rule 701 offerings are not integrated with other offerings. An issuer seeking to issue compensatory equity must also comply with state laws regulating the offer and sale of securities. California in particular can impose additional restrictions, so issuers with employees in the Golden State should be familiar with Section 25102(o) of the California Corporations Code.

Non-Exclusivity. Rule 701 is not the exclusive exemption from federal registration for compensatory transactions. Depending on circumstances, a company might be able to issue securities to employees and consultants pursuant to exemptions for private placements (Section 4(a)(2) of the Securities Act and Regulation D), non-US offerings (Regulation S), or intrastate offerings (Rule 147 or Rule 147A).

Developing Law. With the changing nature of work, the SEC is considering whether to amend the definition of employee to include participants in the “gig economy” who may provide freelance, non-professional services (such as ride-sharing, food delivery and house repairs) to different companies simultaneously and currently may not be issued securities under Rule 701. There have also been calls to revise Rule 701 to allow issuances to entities that provide consulting services. The Corporate Group at FisherBroyles can guide companies through the process of issuing compensatory securities to employees.

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