Awards Pursuant to Written Compensatory Benefit Plans –

Should Securities Act Rule 701 be Updated?

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WARBY PARKER

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Securities Act Rule 701

Overview of Rule 701

What is Rule 701?

- Rule 701 exempts from the registration requirements of Section 5 of the Securities Act, offers and sales of securities issued to certain individuals pursuant to compensatory benefit plans or contracts established by the issuer, its parents, its majority-owned subsidiaries or the majority-owned subsidiaries of the issuer’s parent.

Who can use Rule 701?

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

Overview of Rule 701

Who can Rule 701 be used for?

- Current employees, consultants, advisors, officers, directors, general partners and trustees (where the issuer is a business trust) of the issuer, its parents, its majority-owned subsidiaries or the majority-owned subsidiaries of the issuer’s parent (referred to herein as “Service Providers”).

- Former Service Providers if such persons were employed by, or providing services to, the issuer at the time the securities were offered.

- Family members of the above Service Providers who acquire securities from the Service Providers by gift or domestic relations orders.

Overview of Rule 701

What is not permitted under Rule 701?

- Rule 701 is not available for resales.
- Rule 701 is not available for plans or schemes established to circumvent the compensatory purpose of Rule 701, such as to raise capital.
- Rule 701 is not available for any offer or sale that technically complies with Rule 701 but is part of a plan or scheme to evade the registration requirements of the Securities Act.

Overview of Rule 701

Limitations on Securities Sold in Reliance on Rule 701 – "Hard Cap Limit"

- In any consecutive 12-month period, the issuer may only sell an amount of securities in reliance on Rule 701 equal to the greater of:
  - $1 million in value;
  - 15% of the issuer's total assets based on its most recent balance sheet dated no earlier than its most recent fiscal year end (or those of its parent if the parent guarantees the securities and the issuer is a wholly owned subsidiary); and
  - 15% of the outstanding class of offered securities based on the issuer's most recent balance sheet dated no earlier than its most recent fiscal year end.

- Rule 701 sales or offerings are ***not integrated*** with any other types of offerings made by the issuer (i.e., we only count against the limit, securities sold in reliance on Rule 701).

Overview of Rule 701

Disclosure Required for All

– All recipients of securities under Rule 701 must receive a copy of the compensatory benefit plan or contract.

Additional Disclosure Required for Some – "Soft Cap Limit"

– If the issuer sells securities that is more than $5 million in value in reliance on Rule 701 in any consecutive 12-month period, the issuer must provide the following disclosure "a reasonable period of time" prior to sale:

  – if the plan is subject to the Employee Retirement Income Security Act of 1974 ("ERISA"), a copy of the summary plan description and, if not, a summary of the material terms of the plan;

  – risk factors; and

  – financial statements required to be furnished by Part F/S of Form 1/A (Regulation A Offering Statement), dated no earlier than 180 days before the sale.

Proposed Changes to Rule 701

The Role of Equity Compensation in Private Company Growth & Development

Compensating employees and consultants with equity has become an <u>invaluable tool</u> for private companies to <u>hire</u> service providers necessary for the <u>growth and development</u> of the company.

- At the earliest stages, equity compensation is often the <u>only real form of compensation available</u> to private companies to hire service providers necessary for the development of the company.
  - We recognize that minimum cash compensation is required under Federal and state law, however, it is often a challenge to pay even this minimum compensation at the earliest stages.
- At later stages, equity compensation is <u>critical to recruit talent</u> necessary to continue the growth and development of a company.
  - Competition for talent is intense and equity compensation is generally a necessity.

Challenges with Compliance under the Current Framework

Many private companies, particularly those at the earliest stages, do <u>not have the internal resources or funds</u> to support compliance with rules like Rule 701.

This lack of resources and available expertise can lead to <u>inadvertent compliance issues</u> where there is complexity or substantial cost required to comply with the rules.

Given the importance of equity compensation to the growth and development of private companies, it is critical that the rules related to the issuance of such equity compensation are <u>rational</u> and <u>not unduly complicated</u> and/or <u>difficult to comply with</u>.

Proposed Change: Remove Requirement that Consultants be "Natural Persons"

Revise Definition of Consultants and Advisors to Remove Natural Person Requirement

- Rule 701 is available for consultants and advisors only if:
  - They are "natural persons;"
  - They provide bona fide services to the issuer, its parents, its majority-owned subsidiaries or majority owned subsidiaries of the issuer's parent; and
  - The services are not in connection with the offer or sale of securities in a capital-raising transaction, and do not directly or indirectly promote or maintain a market for the issuer's securities.

Proposed Change: Remove Requirement that Consultants be "Natural Persons"

Background on Private Company use of Consultants and Advisors

- Private companies routinely hire consultants to perform services traditionally performed by employees. This is particularly true for early stage private companies who often cannot afford to engage certain types of service providers full time (e.g., controllers, chief financial officers, human resources support, etc.).
- Most consultants, even individual consultants, will provide their services via an entity created for such purpose. This is often done for tax and liability purposes.
- Under the current rules, companies must jump through hoops in order to compensate these consultants with equity.
  - Sometimes this involves engaging both the individual and the entity as consultants.
  - Alternatively, securities may be sold directly to the entity pursuant to an accredited investor exemption, if available.

Proposed Change: Remove Requirement that Consultants be "Natural Persons"

In the preamble to the 1988 release pursuant to which Rule 701 was first adopted, the Staff noted that there was <u>concern</u> that <u>including consultants would lead to abuse</u> and the use of the rule for non-compensatory purposes.

However, the <u>staff agreed</u> that this concern was <u>not warranted</u> and was adequately addressed by the rules.

"Although the Commission originally believed that broadening the rule to include consultants could go beyond the compensatory purposes of the provision, commenters have repeatedly stated that this limitation is unnecessary because securities issuances to such parties also can be for compensatory and not capital raising purposes and thus there is <u>no meaningful basis for distinguishing between issuances to them and to employees</u>. The Commission has been persuaded by the commenters on this issue. In addition, <u>the concern expressed</u> by the Commission in the July release about use of the rule for non-compensatory purposes is <u>addressed by new Preliminary Note 5</u> and the conditions in the exemption requiring a written plan or contract. Consequently, the rules has been modified to extend to consultants and advisors who provide bona fide services to a company, its parent or majority-owned subsidiaries." Release No. 33-6768 (April 14, 1988) [53FR 12918]

Proposed Change: Remove Requirement that Consultants be "Natural Persons"

In the preamble to the 1999 release pursuant to which Rule 701 was amended, the Staff expressed concern that Rule 701 was being <u>misused for non-compensatory purposes</u> and, in an effort to curb this abuse, aligned the definition of consultant under Rule 701 with the rules set forth for Form S-8 and, in the process, added a requirement that the consultant recipient be a "natural person."

<u>We recommend</u> reverting to the original rule by deleting the requirement that consultants be "natural persons."

- There was <u>no clear rationale</u> expressed for adding the requirement that eligible consultants be "natural persons" and this change <u>does not address the stated concern</u>.
- <u>Enforcement of the rules</u> that prohibit the use of Rule 701 for non-compensatory purposes and services related to capital raising and market-making would be a <u>more appropriate response to curbing abuse of these rules than creating barriers to private companies that are properly using Rule 701 for compensatory purposes</u> by restricting grants to "natural purposes" and increasing the cost and complexity associated with the administration of compensatory benefit plans.

Proposed Change: Eliminate “Hard Cap Limit”

History of “Hard Cap Limit”

- Rule 701 was first adopted pursuant to Section 3(b) of the Securities Act which granted the SEC authority to adopt special exemptions from the registration requirements of the Securities Act for issuances of securities in which the aggregate amount offered does not exceed $5 million.
  - In 1988, the SEC adopted Rule 701 pursuant to this authority

- In October 1996, Congress enacted the National Securities Markets Improvement Act of 1996 ("NSMIA"), which gave the SEC 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 its current form in April 1999.

Proposed Change: Eliminate "Hard Cap Limit"

In the preamble to the 1999 release pursuant to which Rule 701 was amended, the Staff stated that the increase in the "Hard Cap Limit" was being made to provide issuers with the <u>flexibility they need, without creating opportunities for abuse</u>.

<u>We recommend</u> eliminating the "Hard Cap Limit."

- Compliance with the "Hard Cap Limit" requires ongoing analysis with no clear benefit.
- <u>NSMIA removed the requirement to have any limit</u> on compensatory sales made under Rule 701.
- "Hard Cap Limit" on compensatory sales do not address or otherwise curb abuse related to non-compensatory sales.
- <u>Enforcement of the rules</u> that prohibit the use of Rule 701 for non-compensatory purposes and services related to capital raising and market-making would be a <u>more appropriate response to curbing abuse of these rules than creating barriers to, and additional work for, private companies that are properly using Rule 701 for compensatory purposes</u>.

Proposed Change: Adopt Rule Excluding Material Amendments from Calculation of Limit

Rule 701 <u>does not address the implications of amendments</u> of securities previously issued under Rule 701.

However, C&DI 271.10 requires issuers to count stock options that are <u>repriced</u> as <u>new grants/sales</u> under Rule 701 as of the date of the repricing.

<u>We recommend</u> adopting a rule that clarifies that material amendments to any security previously issued under Rule 701 does not result in a new grant or sale for purposes of Rule 701.

- The "repricing rule" can cause companies to exceed the "Hard Cap Limit" and the "Soft Cap Limit" at a time when no additional securities are issued (there is simply a "re-setting" of the original arrangement to ensure the equity is meeting is compensatory objective.
- Clarification would be welcome that other material amendments that do not result in the issuance of additional securities would also not result in a new grant or sale for purposes of Rule 701.

Proposed Change: Clarify Application of Rule 701 to Restricted Stock Units

Rule 701 has <u>no rules</u> specifically <u>addressing restricted stock units</u> (RSUs).

- At the time Rule 701 was adopted, and at the time Rule 701 was later amended, private companies generally did not grant RSUs due to tax issues associated with doing so.

<u>We recommend</u> clarifying the rules as they relate to RSUs.

- Clarify that RSUs are considered "sales" on the date of grant, similar to options.
  - RSUs are derivative securities, like options, where no shares are issued unless and until the RSUs settle (typically upon or after vesting).
- Clarify that RSUs should be valued for purposes of any Rule 701 limits based on the value of the underlying shares on the date of grant.

Proposed Change: Rationalize Timing of Expanded Disclosure Obligation and Measurement Period Applicable to "Soft Cap Limit"

Expanded disclosure must be provided to <u>any person who receives securities under Rule 701 during any 12 month period</u> in which the company <u>sells more than $5 million</u> in value under Rule 701.

- Since the $5 million limit could be <u>exceeded at the end of a 12 month period</u>, but the rule requires disclosure to be provided for any sales under Rule 701 <u>during the 12 month period</u> (or, for options, anyone who exercises options during this time), <u>companies must generally</u> "<u>guess</u>" as to whether the $5 million limit will be exceeded and begin providing disclosure before the disclosure threshold is exceeded in order to ensure compliance.

<u>We recommend</u> changing the rules to provide that expanded disclosure is only required to be provided for sales that occur after the threshold is exceeded.

- The current rule is <u>impractical</u> in its application, with <u>no clear rationale</u> for the structure of the rule.
- <u>Consideration should be given</u> to whether additional time should be given to enable companies to prepare and distribute the disclosure (i.e., a short, buffer period after the threshold is exceeded).

Proposed Change: Clarify Timing and Delivery Requirements of Expanded Disclosure

Rule 701 requires expanded disclosure to be delivered a "reasonable period of time prior to the sale" (or, for options and other derivative securities, exercise or conversion).

We recommend revising the rule to provide that any disclosure delivered at any time prior to sale such that the recipient has an opportunity to review the disclosure satisfies the obligation to deliver disclosure.

We recommend revising the rule to provide that making the disclosure available in a manner consistent with the SEC's electronic disclosure rules (e.g., on an online data site that is accessible to the individual) satisfies the obligation to deliver disclosure and there is no requirement for the issuer to confirm actual receipt or review of such disclosure.

We recommend revising the rule to provide that making the disclosure available in a physical location accessible to the individual satisfies the obligation to provide disclosure.

Proposed Change: Conform Timing of Disclosure Obligation for Options and Restricted Stock Units

Rule 701 requires expanded disclosure to be <u>delivered</u> to option holders a <u>reasonable period of time prior to exercise</u>, and to holders of derivative securities, a reasonable period of time prior to conversion.

However, C&DI 271.24 requires expanded disclosure to be delivered to RSU recipients a reasonable period of time prior to grant.

- In adopting the above C&DI, the SEC distinguished between options and other derivative securities that are exercised or converted, and RSUs, which the SEC acknowledged are derivative securities, that are not exercised or converted.

<u>We recommend</u> adopting a rule that provides that expanded disclosure must only be provided to RSU recipients a <u>reasonable period of time prior to settlement</u>.

- RSUs are derivative securities and should be treated like other derivative securities.
- Although an RSU is not exercised or, technically, converted, it is settled. Prior to settlement, the holder of an RSU holds only a contractual right to receive shares in the future (for no purchase price paid).

Proposed Change: De-Couple Expanded Disclosure from Regulation A and Simplify Required Disclosure

The expanded disclosure required under Rule 701 includes financial statements required to be furnished by Part F/S of Form 1-A (i.e., Regulation A).

- Regulation A was recently revised creating a significant amount of complexity and confusion with regard to its application under Rule 701.
- Some of this complexity was relieved by C&DI 271.21 which allows issuers to choose to follow the requirements of Tier 1 or Tier 2 Regulation A offerings. However, substantial complexity remains.

<u>We recommend</u> <u>simplifying</u> the financial disclosure required under the expanded disclosure requirement by de-coupling it from Regulation A and requiring instead a current balance sheet and income statement.

- In the legislative history to the 1999 release, the SEC stated that Regulation A financial disclosure is something private companies "may be very familiar with" suggesting compliance would not be burdensome. This is generally not true, particularly for companies first subject to the expanded disclosure rules. These companies often <u>struggle and incur significant expense complying</u> with this rule.
- Although audited financials are not required, many companies feel that the equivalent of audited financials must be provided to comply with the rules.
- Consider clarifying whether, and the extent to which, footnotes are required.

Proposed Change: Change the Frequency in which Financial Disclosure must be Updated

Rule 701 requires financial disclosure provided under the expanded disclosure rules to be dated as of a date <u>no more than 180 days</u> before the sale.

We believe the expectation of this rule was that financial disclosure would only need to be updated and provided every six months.

However, it takes time to prepare the financial disclosure that must be provided. As a result, financial disclosure <u>must generally be updated and provided quarterly</u>.

<u>We recommend</u> revising the rules to require financial disclosure to be updated and provided <u>once a year unless a material event</u> results in a <u>material change</u> to the <u>enterprise value</u> of the company or the <u>value of the securities</u> to be issued.

- The current rule is <u>unduly burdensome</u> and <u>costly</u> for private companies.
- The proposed rule generally conforms to the IRS rule that requires companies to value private company stock for purposes of pricing stock option grants, which strikes a <u>reasonable balance</u> between ensuring <u>disclosure is appropriate</u> and the <u>cost and burden</u> imposed on the company to prepare such disclosure.

Proposed Change: Conform Consequence of Expanded Disclosure Violation to "Hard Cap Limit" Violation

A violation of the "Hard Cap Limit" results in the loss of the Rule 701 exemption <u>only for securities sold in excess</u> of the Hard Cap Limit.

A violation of the expanded disclosure obligation results in the loss of the Rule 701 exemption for <u>all securities sold in the applicable 12-month period</u>.

<u>We recommend</u> conforming the consequence of violating the expanded disclosure obligation, with the consequence of violating the "Hard Cap Limit" such that only those sales pursuant to which expanded disclosure was not provided lose the Rule 701 exemption.

- Often times, a failure to provided expanded disclosure, is an <u>inadvertent</u> result of an administrative error.
- There is <u>no clear rationale</u> for the <u>punitive result</u> of the current rules.
- Under the proposed rules, if there is a broad-based failure to provide expanded disclosure, there will be a broad-based loss of the Rule 701 exemption.

Proposed Change: Increase the "Soft Cap Limit"

Many commentators have called for an increase to the $5 million "Soft Cap Limit."

<u>We recommend</u> increasing the $5 million "Soft Cap Limit" to at least $10 million.

- The current $5 million "Soft Cap" limit has been a surprise to many smaller companies that generally do not expect to be subject to a burdensome disclosure obligation in connection with the issuance of equity compensation to their employees and consultants.
- This "surprise," combined with the look-back nature of the current rule and the "repricing rule," has resulted in inadvertent compliance issues for some companies.
- The hire of a key employee can result in an equity grant that results in exceeding the $5 million "Soft Cap Limit" at a time when the "Soft Cap Limit" would not otherwise be exceeded.
  - These grants can be 5-10% of the fully diluted outstanding shares of a company and represent a grant date value in excess of $5 million.

orrick

WARBY PARKER