# RULE 701 AMENDMENT ENCOURAGES STOCK OPTION AND OTHER EQUITY-BASED COMPENSATION PLANS

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I. Executive Summary: On July 18, 2018, the Securities and Exchange Commission ("SEC") adopted final rules to amend Securities Act Rule 701, which provides an exemption from the Securities Act of 1933 (the "Securities Act") public registration requirements of certain securities issued pursuant to compensatory benefit plans such as stock option, stock appreciation, profit sharing, incentive, deferred compensation, and pension plans by most private (non-reporting) companies. The new amendment, which is open for public comment, increases *from $5 million to $10 million* the securities issuance threshold at which the issuer is required to provide additional disclosures to investors (the employees receiving the equity-based compensation), thereby allowing higher dollar size option plans, for example, at lower cost, time, and effort to the company employer issuer. The SEC stated that the amended rule should encourage non-traditional short-term, freelance work relationships typical of the new "gig economy." For cash-strapped early stage businesses, especially in the technology sectors, stock options and other equity-based compensation have long been a way to secure employee or consultant talent that they could not with a cash salary. Also, both mature U.S. businesses and inbound non-U.S. businesses use stock option and other compensatory benefit plans to secure employee talent with vesting schedules and other incentivizing provisions. The Rule 701 amendments should encourage and facilitate greater use of equity-based compensation for all these situations.

This advisory discusses Rule 701 and stock option plan basics. For a full discussion of the other major exemptions to Securities Act registration, see our "Raising Capital through Private Placements: Deal Points," available at www.kurtinlaw.com or by request at info@kurtinlaw.com. It is worth noting that while Rule 701 may not be used solely to raise capital, the ability it provides to issue stock or rights to purchase stock to employees and others in lieu of cash theoretically frees up available capital for other purposes.

II. Rule 701 Basics: Securities Issued as Compensation for Directors, Officers and Employees.

The Rule 701 exemption from registration of securities is not available to Securities Exchange Act of 1934 (the "Exchange Act") reporting companies or companies required to register under the Investment Company Act of 1940. Investors receiving Rule 701 securities must be officers, directors, employees, consultants, or advisors of the issuer employer who are receiving the securities pursuant to a written compensatory benefit plan such as a stock option, stock appreciation, profit sharing, incentive, deferred

compensation, or pension plans, or as part of an individual written employment agreement. There are no other investor sophistication requirements. As stated earlier, Rule 701 may not be used for capital-raising purposes, although the use of compensatory benefit plans may free up available capital for other use.

For the Rule 701 exemption to be available, securities sold under it during the prior 12 months are limited to the greater of: $1 million, or 15% of the issuer's total assets (or issuer's parent if issuer is a wholly-owned subsidiary of parent and parent unconditionally guarantees the securities), or 15% of issuer's outstanding securities of the same class. Rule 701 securities are not integrated with any other exempt or registered offers or sales, meaning that securities offered under any other Securities Act sections, rules, or regulations do not count against the foregoing limits. There is no requirement to file the compensatory benefit plan or contract with the SEC. Securities issued under the Rule 701 exemption are restricted securities that can only be resold if registered or with a resale exemption, including the exemption provided by Rule 701 if issuer becomes an Exchange Act reporting company after their issuance.

The written compensatory benefit plan or contract, as the case may be, must be provided to the investor employee. There are no specific information requirements except a copy of the compensatory benefit plan or contract unless more than $5 million ($10 million once the current amendment becomes effective) in securities are offered in a 12-month period, in which case certain specific disclosure information specified in the Rule must be provided. Nevertheless, as always, the anti-fraud provisions of the securities laws and regulations apply.

The limited applicability of Rule 701 is expressly adapted for executive and employee securities-based compensation. Because the exempted securities become available for resale only months after the issuer becomes an Exchange Act reporting company or the resale restriction is otherwise removed, the Rule 701 exemption is ideal for executive stock awards and stock option plans for which the issuer wishes to bind the employee to the company until it conducts an initial public offering or otherwise becomes a reporting company. When the exemption is combined with vesting cliffs in a stock option plan, for example, the issuer has extensive leverage to retain key employees.

III. Stock Option Basics.

One of the main uses of Rule 701 is to issue exempt securities through stock option plans. The employee stock options we are discussing are technically "call" options, ones that give the option holder

employee the right – the option - to purchase the issuer employer's stock at a specified price (the "exercise" or "strike" price) within a certain time period in the expectation that the stock's (or other security's) fair value price will rise after exercise of the option ("put" options give the holder the right to sell at a specified exercise price; a put option holder hopes and expects fair value to decline below the exercise price). Typical employee call options for which the underlying shares have risen in value above the exercise price are said to be "in the money;" options for which the fair value of the underlying shares has fallen below the exercise price are said to be "underwater" – in other words, nobody who held such an option would want to exercise it.

Employee stock options come in two varieties: non-qualified stock options, and qualified, or "incentive" stock options ("ISOs"). Non-qualified options need not be issued pursuant to an option plan, although, to take advantage of Rule 701, the option grant must be in written form. Assuming some basic compliance, the holder of the options will owe no tax on them until the option is exercised, at which time the employee will incur an income tax liability on the spread between fair market value and the exercise price. The issuing company receives a corresponding tax deduction.

By contrast, ISOs are required by U.S. Internal Revenue Code ("IRC") §422 to be issued pursuant to an written option plan, must have an exercise price of at least 100% of fair market value at the time of issuance and must expire within 10 years. When properly structured, the option holder incurs no income tax liability when the option is exercised, but only upon a later resale of the shares purchased by exercise of the option. Assuming the stock has been held for long enough, even that tax liability will be calculated at the lower long-term capital gains, rather than higher ordinary income, tax rates. The company receives no tax deduction.

For these reasons, option-issuing companies generally prefer to issue non-qualified options, while employees prefer to receive ISOs. However, given the use of options to attract and retain employees in the absence of ready cash, the ISO has been a dominant form of option grant. Options are valued pursuant to several econometric models that attempt to account for volatility of the underlying securities before the option is exercised, the best known of which is the Black-Scholes model, which, for an option with an exercise price equal to fair value at the time of grant, usually yields a valuation of 20 - 40% of the value of the underlying stock. In other words, options are priced, and cost the issuing company, 20 - 40% of what an equivalent stock issuance or cash payment to the employee would cost. Other option valuation models include so-called "Lattice" models, like the Binomial model and Trinomial tree, and the Monte Carlo model.

Note that SEC Rule 701 and IRC §422 operate independently: Rule 701 governs whether an exemption from Securities Act public registration is available. IRC §422 governs whether the tax benefits for ISOs are available. A mishandled option grant could for example, comply with Rule 701 and not §422, or vice versa.

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