Dodd-Frank Revisions Benefit Private Companies: Congress Doubles Enhanced Disclosure Trigger for Equity Compensation Awards Under Rule 701

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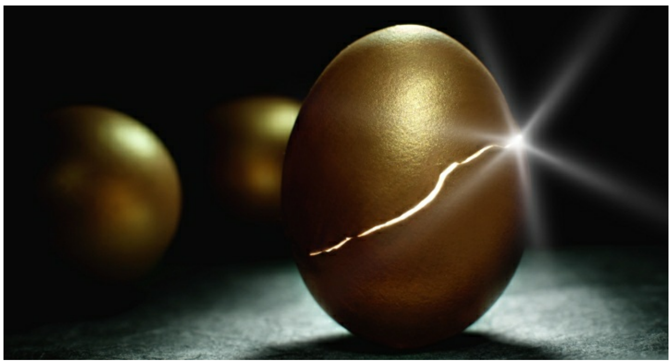

The Economic Growth, Regulatory Relief, and Consumer Protection Act (the 'Act') hit national news channels in late May 2018 due to its sweeping relief from provisions of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act provided to smaller financial institutions and community banks.

But the Act also implemented provisions designed to encourage capital formation for private companies, many of which did not make national headlines.

This article addresses Title V of the Act which provides private companies relief from enhanced disclosure requirements when making equity compensation awards to employees by directing the Securities and Exchange Commission (the “SEC”) to increase the threshold amount triggering enhanced disclosures under Rule 701 of the Securities Act of 1933, as amended (the "Securities Act"), from $5 million to $10 million.

Why Does This Matter to My Company?

When assessing how best to compensate and incentivize employees, your privately owned company may have decided, or may decide in the future, to turn to some form of equity compensation as an alternative to high salaries or cash bonus arrangements. Equity compensation awards can take a variety of forms, the most common of which include:

- Stock options (or "profits interests" for limited liability companies);
- Restricted stock awards;
- Restricted stock units ("RSUs");
- Phantom stock; and,
- Stock appreciation rights ("SARs")

A well-designed equity compensation plan can help your company reduce cash flow (by reducing salaries) while giving it tools to incentivize future performance and remunerate employees for past work performed.

While private companies are accustomed to addressing the various tax and accounting issues that can arise in connection with implementation of an equity compensation plan or one-off awards, the implications of federal and state securities laws can often be overlooked.

In most cases, equity compensation awards of this nature are considered "securities" under federal and state law. As a result, if your company utilizes, or decides in the future to utilize equity compensation arrangements, you need to implement procedures to ensure compliance with exemptions from the registration requirements imposed under Section 5 of the Securities Act, as well as applicable state laws.

Rule 701 of the Securities Act ("Rule 701") provides such exemption and is most commonly used by private companies making "broad-based" equity awards (i.e., awards beyond the company's C-suite employees) on a regular basis.

Rule 701 and Equity Compensation Awards

Rule 701 provides an exemption from the registration requirements of the Securities Act for offers and sales of securities by private companies. (Public companies typically register securities offered under equity compensation programs with the SEC through the use of a specialized Form S-8 registration statement.).

If your privately owned company offers or decides to offer, equity compensation awards, you should establish procedures to track equity compensation awards to ensure your company's compliance with the following Rule 701 requirements. The awards must be:

- In Writing. Awards must be made pursuant to a written compensatory benefit plan or agreement, so Rule 701 works for one-off awards made pursuant to a written contract or one or more series of awards made under a written compensation plan.
- To Individuals Who are Current Providers of Services. Rule 701 awards may only be made to current:
    - Employees;
    - Directors;
    - Officers; and,
    - Consultants/and advisors.

  Rule 701 also covers awards transferred to certain family members of the above service providers through gifts or domestic relations orders. All of the grantees (including consultants and advisors) must be individuals (i.e., natural persons) and, if made to a consultant or advisor, the awards must be made in connection with the provision of bona fide services to your company (as long as they are not provided in furtherance of any capital raising transactions or to promote your company's securities).

  This means that Rule 701 will not cover awards to corporations, partnerships, or limited liability companies (even if single-member) or those made to compensate consultants or advisors who assist in raising capital. (Awards of this nature are typically structured to fall within private placement exemptions since they cannot qualify under Rule 701.)
- Within Caps. Rule 701 awards made in any 12-consecutive month period may not exceed the greater of:
    - $1,000,000 in the aggregate;
    - 15% of your company's total assets;
    - 15% of the outstanding securities of the class of equity covered by the award.

  For these purposes, the "aggregate sales price" includes the value of stock options (determined by multiplying the total number of shares covered by the award by the exercise price) on the date of grant, rather than the date the option is exercised.

- Accompanied with Copies of Plan. All Rule 701 awards must be accompanied by a copy of the plan or contract under which the securities are granted.
- Provided with Enhanced Disclosures If Threshold Amount Surpassed. If the aggregate sales price of all awards exceeds a specific threshold amount (currently $5 million) in any 12 month period, Rule 701 requires your company to provide all grantees enhanced disclosures, including:
  - Risk factors;
  - A summary of the plan or agreement governing the award (including the plan description required by ERISA, if applicable); and,
  - Financial statements that are no more than 180 days old (including audited financials, if available). If triggered, the enhanced disclosure must be provided a reasonable period of time prior to the exercise of any options or prior to sale for restricted stock, RSUs, SARs, and other securities. The enhanced disclosure requirement is also retroactive, applying to all awards made in the 12-month period including those made prior to exceeding the threshold amount.

    The retrospective nature of the enhanced disclosure triggers requires your company to carefully monitor and predict annual award activity. This can add uncertainty for the availability of the exemption, particularly if your company is a larger, seasoned one or a late-stage startup making significant annual awards at a high price, forcing unnecessary risk of inadvertent securities laws violations. The Act provides relief by requiring the SEC to revise Rule 701 to double the threshold trigger from $5 million to $10 million.

Alternatively, your company may also use "private placement" exemptions (primarily under Rule 506(b) of the Securities Act or Section 4(a)(2) of the Securities Act) to exempt equity awards that do not fall within the scope of Rule 701, particularly those made to executive officers, directors, high-salaried employees, and consultants that qualify as "accredited investors," as that term is defined under the Securities Act.

Conclusion

Congratulations on having a prosperous private company. You certainly want to award your high-performing officers, directors, employees, and consultants to keep them loyal and motivated, but you should work with an experienced attorney and advisors when setting up and managing your equity compensation plan.

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