A Practical Review of Rule 701 in Equity Compensation Award Administration

Disclaimer: This summary is intended only as a high level overview. It is not intended to be legal advice. SOS recommends clients consult their professional advisors before taking action in order to understand the impact that information discussed here can have on stock based compensation and equity systems/databases.

Background: After the first stock market crash in the early 20th century, the United States Congress established the Securities and Exchange Commission and implemented the Securities Act of 1933 (the "Act"). Section 5 of the Act requires that any stock or instrument convertible into stock must be registered with the SEC before it can legally be sold. Included in this definition of covered equity instruments are those that stock and option plan administrators deal with on a daily basis – though most private company administrators have never even considered that their awards would require registration with the SEC. The good news is, as with most such laws, there are exemptions available when enforcement of the law would be burdensome to the affected party, such as certain privately held companies.

Exemption from registration: There are exemptions for purchasers, exemptions for sellers, and exemptions for issuers. Rule 701 of the Act, provides a safe-harbor exemption from the registration requirements of Section 5 of the Act for offers and sales by pre-IPO issuing companies. Stockholders of the issuer may not rely on Rule 701 to offer or sell unregistered stock purchased from the issuing company.

To be eligible for an exemption under Rule 701, the issuing company must not be subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act"). Once a company becomes subject to reporting under the Exchange Act, it can no longer rely on Rule 701 to make new offers of securities but can continue to rely on Rule 701 to sell securities previously offered. An example would be options issued pre-IPO in reliance on Rule 701 and the exercise of those options post-IPO.

To rely on Rule 701, a company's securities (stock, options, or any type of award that is convertible into stock) must meet these basic requirements:

- **Award** – issued under a written compensatory contract or compensatory benefit plan.
- **Recipients** – issued only to natural persons.
- **Quantity or Value Test** – pass one of three tests based on the quantity or value of the issuance in relation to the issuer's outstanding securities or total assets.

Award: The award must be issued under a written compensation contract or a compensatory benefit plan and a copy of the plan must be provided to the award recipient. The purpose of the issuance must be compensation for actual services rendered, either to the issuer, its parent company or a majority-owned subsidiary. A plan is not limited to granting only to Rule 701 eligible recipients, thus not all issuances under such a written contract or plan are automatically eligible for the Rule 701 exemption.

Recipients: Rule 701 exempt awards may be made only to natural persons. Thus, while consultants are eligible recipients, consulting firms are not. Likewise, certain trustees are eligible, but trusts are not. The recipient must be an active service provider when the award is granted. The exemption will also apply to certain family members of eligible recipients who acquire the securities through gifts or domestic relations orders, as well as insurance agents who, though not employees, meet certain exclusivity requirements in relationship to the company. Grants to persons whose primary service is promotional or capital-raising are specifically prohibited

Test: There are three possible tests to establish an award's eligibility under Rule 701. For a company to use Rule 701, the issuance cannot exceed the greater of:

TEST #1: $1 million, the sum of the exercise price of outstanding options (including the current issuance) plus the aggregate dollar amount of sales made in reliance of Rule 701 during the preceding 12 months,

- Example – current grant value $240,000.00 plus previously granted (in testing period) $700,000.00 plus aggregate dollar of Rule 701 sales (in testing period) $75,000.00 Total test calculation: $240,000 + $700,000 + $75,000 = $1,015,000 TEST FAIL: exceeds $1 million by $15,000

TEST #2: 15% of the outstanding securities of the same class of stock, the sum of the new award(s) plus outstanding Rule 701 awards issued during the preceding 12 months,

- Example – current grant quantity 1,500,000 shares of Common stock plus previously granted Rule 701 awards (in testing period) 12,700,000 shares Current outstanding Common stock 63,000,000 Total test calculation: 63,000,000 * 15% = 9,450,000 shares Current 1,500,000 + 12,700,000 = 14,200,000 shares granted TEST FAIL: exceeds 15% by 4,750,000 shares

TEST #3: 15% of the company's total assets measured as of the most recent balance sheet if no older than the last fiscal year end, the sum of the exercise price of outstanding options plus the aggregate dollar amount of sales made in reliance of Rule 701 during the preceding 12 months.

- Example – current grant total exercise price $240,000.00 plus exercise price of previously granted (in testing period) $700,000.00 plus aggregate dollar of Rule 701 sales (in testing period) $75,000.00 Total test calculation: $240,000 + $700,000 + $75,000 = $1,015,000 Company’s total assets @ FYE: $108,000,000 * 15% = $16,200,000 TEST PASS: $16,200,000 - $1,015,000 = $15,185,000 (under 15%)

As a practical matter, most equity compensation administration platforms have a Rule 701 testing function which should be run every time a new set of grants is entered. The awards must be entered chronologically and the direct stock issuances must be up to date because the calculation is based on grant date and covers the 12 months preceding that date. If even one of the three tests is passed, then the awards are Rule 701 eligible issuances.

If none of the tests are passed, then the company can no longer rely on Rule 701 for future issuances.

There are a few practical courses of action that can be taken to remedy or avoid that disqualification:

Check the balance sheet date. This is the first step that should be taken when all the Rule 701 tests fail. The administration platform will usually ask for a most recent balance sheet date in order to run the report. As an outsource administrator, it’s often challenging to know when the client company’s most recent balance sheet is. While using the calendar year end or the fiscal year end is the most common best guess, those dates can sometimes be problematic because many platforms don’t include issuance transactions after the balance sheet date. Such exclusions could include a more recent securities issuance that would impact the calculation, such as a preferred stock issuance with common stock or common warrant side issuances, or a significant amount of current exercises. One other place to check for a current balance sheet date is the most recent 409A valuation report. If that report is on file, it will usually contain a copy of the company’s balance sheet upon which the valuation is partially based. Another place to look is in the most current preferred stock financing closing binder. Once you find a more current balance sheet date, update your report parameters and run the report again. If the test failure isn’t remedied, the next steps will provide ways to avoid going over the testing limits.

Reduce Rule 701 shares in grant calculation period. Rule 701 allows the issuer to eliminate from the calculation period any grants which were cancelled or forfeit within twelve months of issuance. An example would be a grant that was made 11 months ago (and thus within the current grant’s 12 month calculation period) but which was cancelled due to termination four months after issuance. Some administration platforms do not automatically make this reduction, so the administrator may be required to do a manual calculation.

Reclassify grants to certain individuals. Oftentimes, company executives and directors are qualified as “accredited” or “sophisticated” investors based on their net worth, annual income and investment experience. Grants to these individuals can be eligible for other exemptions from registration for private or

limited offerings such as the Section 4(a)(2) private offering registration and limited offering exemptions available under Regulation D, Rules 504, 505 and 506. There is also an exemption for offerings to non-US recipients under Regulation S. Reclassifying historic and/or current awards to any these individuals can reduce the outstanding Rule 701 securities in the reporting period and have the potential to reduce the current grants below the testing limits. Even if the administrator knows the investment status of the award recipients, s/he will want to verify with legal counsel the availability of alternative exemptions and obtain permission of the award recipients because the holding periods under the alternative exemptions differ from those under Rule 701.

Redefine the testing period. The statute repeatedly states "during the preceding 12 months" but the SEC has allowed for companies to adopt a fixed 12-month period (usually the calendar year or fiscal year) instead of the rolling 12-month period. As with everything about equity compensation, consistency in practice is paramount. Once the company makes this decision, they will want to stick with it. Changing back and forth will raise a red flag and can have serious consequences. Since most administrative platforms are configured to run the Rule 701 tests based on the rolling 12-month period, electing to use a fixed 12-month period will likely require the administrator to maintain a manual workbook for testing at each new grant issuance. This can become complicated when judging which shares should and should not be included in the testing calculations and when to do the calculation. Rule 701, Section (d)(3)(ii) states that for option grants, the aggregate sales price is determined on the grant date, but for other securities, such as restricted stock, the aggregate sales price is determined on the sale (exercise) date, and for deferred compensation instruments, the price is calculated as of the date the irrevocable deferral is made – but since those future dates are unknowable, you'll have to decide whether or not to substitute the grant date price for testing purposes. Likewise, you'll want to remember that if the Rule 701 awards are issued for the company's Common stock, then the outstanding Common in Test #2 will be based upon the number of outstanding Common, plus the number of exercisable non-Rule 701 Common awards (such as awards to entities or other recategorized awards), plus the number of shares of other stock, like Preferred stock, that are convertible into Common (at the conversion rate).

Sale of unregistered securities. Rule 701 is an exemption for the offer and sale of unregistered securities by the issuer company. The exemption that applies to sales of unregistered stock by the shareholder is Rule 144. Rule 144 is an entirely different discussion. For the purpose of this Rule 701 discussion, the ability for a shareholder to sell shares issued by the company in reliance on Rule 701 will depend upon the status of the shareholder – affiliate or non-affiliate. Rule 144 defines an affiliate as a person that directly or indirectly controls, is controlled by, or is under common control with the issuing company. All directors and certain key executive officers are deemed to be in control due to the nature of their responsibilities within the issuing company.

Sales by Non-affiliates. Under Rule 701, 90 days after the issuer's IPO, non-affiliates can sell their stock in a brokers' transaction as defined under Rule 144, without regard to the Rule 144 holding periods.

Sales by Affiliates. Sales of stock by affiliates are always under Rule 144. Stock acquired by an affiliate from the issuer in reliance on Rule 701 must be resold in accordance with Rule 144, but the regular 144 holding periods will not apply.

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