

Locke Lord QuickStudy: SEC Amends Rule 701 TO Increase Disclosure Threshold and Seeks Comment on Further Changes for Compensatory Awards

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On July 18, the Securities and Exchange Commission adopted an amendment to Rule 701 increasing the threshold that triggers the Rule's disclosure requirements. As background, Rule 701 provides an exemption from the registration requirements of the Securities Act for offers and sales of securities (including securities issuable under stock options and restricted stock units) by private companies (i.e., companies not subject to the reporting requirements under the Exchange Act) to their employees, officers, directors, consultants and advisors under compensatory benefit plans. If the aggregate sales price or amount of securities granted to service providers during any consecutive 12-month period exceeds \$5 million, companies must deliver to participants a reasonable time before the sale financial statements, the risk factors associated with the investment, and a summary of the plan's material terms. For stock options, this means a reasonable time prior to exercise. For other securities, it means prior to the date of grant. The disclosure requirements are applied retroactively to all sales made in the applicable 12-month period, and not just to those once the company has exceeded the limit.

As mandated by the Economic Growth, Regulatory Relief and Consumer Protection Act (which was signed by President Trump in May 2018), the SEC amended Rule 701(e) to increase the threshold that triggers the requirement to deliver disclosures from \$5 million to \$10 million. In all other respects, Rule 701(e) will continue to operate in the same manner as it currently does. Thus, if the aggregate sales during any consecutive 12-month period exceed \$10 million, the company must deliver the disclosures within a reasonable period of time before the date of sale to all investors in that 12-month period. Companies that have commenced an offering in the current 12-month period will be able to apply the new \$10 million disclosure threshold immediately upon effectiveness of the amendment. In this regard, a company that has crossed the \$5 million threshold (but not the \$10 million threshold) must comply with the disclosure requirements for those investors entitled to such information before the effective date of the amendment, but once the amendment becomes effective, the company is not required to provide further disclosures unless the \$10 million threshold is exceeded (applied retroactively for the 12-month look-back period).

This amendment to Rule 701 follows an enforcement action brought by the SEC in March 2018 against Credit Karma, Inc., a privately-held internet-based financial technology company. From October 2014 to September 2015, Credit Karma issued \$13.8 million of stock options to employees, but failed to provide the disclosures required by Rule 701 even though senior executives were aware of the Rule 701 requirements. Credit Karma agreed to a settlement with the SEC and paid a civil penalty of \$160,000.

The SEC also voted to issue a concept release requesting public comment on ways to modernize Rule 701 and

Form S-8 (the registration statement for compensatory offerings by reporting companies) in light of the significant evolution in both the types of compensatory offerings and the composition of the workforce since the SEC last substantively amended these rules in 1999. In particular, the SEC is asking for comments regarding “gig economy” relationships, to better understand how they work and to determine what attributes of these relationships may provide a basis for extending eligibility for the Rule 701 exemption to these workers.

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