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SEC Proposes Changes to Equity Compensation Rules for Public and Private Companies

WRITTEN BY

Stanley Keller

The Securities and Exchange Commission, on November 24, 2020, proposed changes to the rules and forms that are used for compensatory securities offerings by both private and public companies. If adopted, the changes should give added flexibility to companies using equity as part of their compensation programs for employees, directors and consultants. At the same time, but in a separate release, the SEC proposed to extend eligibility under these rules and forms to participants in the so-called "gig economy" for five years.

Proposed Rule 701 Changes

Rule 701 provides an exemption for offers and sales of securities by a private company under a written compensatory benefit plan or written compensation contract for employees, directors and consultants, among others. Use of the rule is subject to volume limits and information requirements, including a requirement to provide financial statements if more than $10 million is sold in any 12-month period. The changes proposed by the SEC would:

- Require disclosure of the additional financial and other information mandated by Rule 701(e) only with respect to those sales that exceed the rule's $10 million threshold in a 12-month period. The current rule requires this information to be provided with respect to all sales during the 12-month period if the threshold is exceeded, which requires issuers to anticipate whether they will exceed the threshold or risk losing the exemption entirely.
- Conform the requirements for the age of financial statements to those in Part F/S of Form 1-A under Regulation A. If financial statements are required, the current rule requires them to be prepared quarterly for offers to be made on an uninterrupted basis. The change would permit financial statements of both US and non-US companies to be prepared instead on a semi-annual basis.
- Permit non-US issuers that are exempt from SEC reporting under Rule 12g3-2(b), by virtue of being listed on an overseas exchange, to provide financial statements prepared in accordance with home country standards without reconciliation, if financial statements prepared under US GAAP or international accounting standards (IFRS) are not otherwise available.
- Allow issuers to provide, in lieu of financial statements, an independent report on the fair market value of the offered securities prepared for purposes of Section 409A of the Internal Revenue Code. The report would need to present a valuation within six months of the date of sale. Non-US issuers using the Rule 12g3-2(b) exemption could simply disclose the fair market value of the stock on the trading day preceding the sale.
- Permit companies to delay any required grant date financial statement disclosures to 14 days after hire for new employees. The change would alleviate concerns over sharing confidential information prior to the start of a person's employment. It will not affect the grant of stock options, where any required information must be provided a reasonable time prior to exercise rather than prior to grant.
- Clarify the application of the Rule 701 volume limits to options or other derivative securities adopted by the

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acquirer in a merger transaction.

- Increase the amount of securities that may be sold under Rule 701 during any consecutive 12-month period to the greater of $2 million (increased from $1 million), 25% of the total assets of the issuer (increased from 15%), or 15% of the outstanding amount of the class of securities being offered or sold (unchanged).
- Permit entities to receive Rule 701 securities as a consultant or adviser, if substantially all of the activities of the entity involve the performance of services, and substantially all of the ownership interests of the entity are held directly by not more than 25 natural persons, of whom at least 50% perform such services for the issuer through the entity. Under the current rule, entities can receive grants under Rule 701 only if they are the wholly-owned "alter ego" of the service provider.
- Extend Rule 701's availability to cover former employees receiving post-termination grants as compensation for services rendered within 12 months preceding the termination, and to cover terminated employees of an acquired entity where the securities are issued in exchange for securities of the acquired entity issued as compensation during the person's employment with the acquired entity.
- Expand eligibility to subsidiaries, not just majority-owned subsidiaries, of the issuer or the issuer's parent.

While the rule changes will provide welcome flexibility to private companies who use equity as an element of their compensation programs, the SEC notably did not take the opportunity to address one area of existing uncertainty under Rule 701, which is the appropriate valuation of "profits interests" issued by pass-through entities such as limited liability companies or partnerships under the rule's volume limits. Profits interests are frequently used for management or other employees of LLCs or limited partnerships as a rough analog to stock options in a corporation, by offering participation in future growth of the company. Subject to certain conditions, the IRS treats qualifying profits interests as having zero value at grant, under IRS Revenue Procedures 93-27 and 2001-43. The SEC has never clarified whether the IRS method could be applied, or whether some other valuation method should be used. The proposed changes do not address the issue, but it would be helpful if the SEC does so.

Proposed Form S-8 Changes

Public companies are ineligible to use Rule 701, but instead can register the offer and sale of compensatory equity awards on a streamlined registration statement on Form S-8. The SEC's proposed changes to that form would:

- Clarify that under existing rules, issuers may add additional plans to an existing Form S-8 through an automatically effective post-effective amendment where the additional plan does not require the registration of additional securities for offer and sale.
- Clarify that issuers are not required to allocate registered securities among compensatory plans and may use a single Form S-8 for multiple plans, effectively allowing issuers to register a pool of registered shares that may be used under various plans.
- Amend Rule 413 to permit issuers to add securities to an existing Form S-8 by filing an automatically effective post-effective amendment. Under current rules, an issuer needs to file a new Form S-8 to register the offer and sale of additional securities under a new or existing plan.
- Require issuers to pay registration fees for shares sold under defined contribution plans on an annual basis in arrears, based on the aggregate offering price of securities sold. Current rules result in issuers estimating the potential number of future sales based on employee elections and historical usage, and require payment of the filing fee at the time of filing, which can result in the over- or under-estimation of shares to be sold.
- Conform Form S-8 eligibility rules to the proposed changes to Rule 701 described above, including those relating to former employees and to consultants and advisers that organize as entities.
- Make changes to the exhibit requirements and undertakings for ERISA-qualified plans in light of changed IRS practices in issuing determination letters.
- Remove requirements in Form S-8 to disclose the tax effects, if any, on the issuer in the plan prospectus to be

delivered to participants.

Proposed Temporary Inclusion of Gig Economy Workers

In its July 2018 concept release, the SEC requested comment on how its rules and forms relating to the compensatory use of equity for a company's employees might address the changing nature of employment relationships, and in particular the new types of relationships between companies and individuals in the so-called "gig economy" that encompasses ride-sharing, food delivery, home repair, tech support, dog-walking and other services. The SEC has now proposed to include these workers, who do not have a traditional employment relationship with a company, within an expanded group of persons to whom offers and sales may be made under Rule 701 and Form S-8. To allay concerns that the expansion will lead to the use of the rule for capital-raising purposes or other abuses, and to give the SEC time to evaluate the changing nature of the workforce, the proposed rule change would be temporary, expiring after five years.

The temporary rule would permit issuers to offer compensatory securities to "platform workers," meaning workers otherwise unaffiliated with the issuer who provide bona fide services through or by means of the issuer's internet-based or other widespread, technology-based marketplace platform. To use the rule:

- The issuer must operate and control the platform, including having the ability to provide access to the platform, to establish the terms of use and payment, and to accept and remove platform workers using the platform.
- The issuance of securities to platform workers must be pursuant to a written compensation plan, contract or agreement, and not for capital-raising services.
- No more than 15% of the compensation received by a platform worker during a 12-month period, and no more than $75,000 during a 36-month period, may consist of securities.
- The amount and terms of securities issued to a platform worker may not be subject to individual bargaining or a worker's option to choose between securities and cash.
- For private companies using Rule 701, the issuer must take steps to prohibit the transfer of the offered securities other than by operation of law. As proposed, these transfer restrictions would last indefinitely, although under Rule 701(g)(3) the securities could be resold 90 days after an issuer becomes an SEC reporting company.

The rule would be limited to workers who provide services over qualifying platforms, and would not be available to platforms used for the sale of goods. Issuers using these rules would be required to furnish information to the SEC at six-month intervals to help it assess the utility of the rules and whether to extend the changes past their initial expiration. Rule 12g5-1 would be amended so that platform workers who are issued securities by non-reporting companies under these temporary rules would be excluded from the definition of "holders of record" for the purpose of determining whether a company is required to register its equity securities under Section 12(g) of the Securities Exchange Act, similar to that rule's current exclusion of securities issued under employee compensation plans.

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These proposed changes are open to public comment for 60 days after publication in the Federal Register, and so remain subject to change. Several SEC commissioners indicated that they would favor broader coverage by the temporary rule for platform workers.

If you have any questions about the proposed changes or related topics, your regular Locke Lord contact or any of the authors can discuss these matters with you.

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