



# Rule 701 Compliance

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## Why is this topic important?

- Compliance with securities laws is important to investors (in private and public markets), underwriters...and, of course, regulators
- Requirements for compliance can be easy to miss; many areas require judgment and advance planning
- Failure to comply can result in negative consequences for the company and those who control the company
  - Remedies for failure to comply may cost the company significant time and expense
  - Potential SEC enforcement action – including fines and/or other penalties
  - Increased time dealing with the SEC through the IPO process
  - Disclosure requirements in any IPO prospectus and potentially going forward



## Rule 701 – What is it?

- Baseline rule is that all sales of securities have to either be done through a registered offering (like an IPO) or be exempt from the registration requirements
- Rule 701 is a federal exemption from registration requirements for offers and sales of compensatory equity awards (options, restricted stock, etc.) by a private company
  - *Not available for capital raising transactions*
- Generally covers issuances under an equity plan to directors, officers, other employees, consultants and advisors
  - Consultants and advisors must (i) be natural persons, (ii) provide bona fide services and (iii) not provide services in connection with the offer and sale of securities, in a capital raising transaction or promote or maintain a market for the company's securities
- Exemption is not exclusive – companies may also rely on other exemptions such as 4(a)(2) (private placement), Regulation D (private placement) or Regulation S (foreign offerings)



## Rule 701 – Conditions to be Met

- The amount of securities that may be sold during any consecutive 12 month period in reliance on Rule 701 may not exceed the greatest of:
  - \$1,000,000
  - 15% of total assets (measured at the most recent balance sheet)
  - 15% of class outstanding (measured at the most recent balance sheet)
- RSUs, Restricted Stock Awards and Options are treated as “sold” for purposes of these 701 limits at the time of grant
  - Value = exercise price (options) or FMV (RSUs and Restricted Stock)
- If aggregate sales price or amount of securities sold in any consecutive 12 month period exceeds \$5 million, the company must provide certain disclosures to the award recipient a reasonable period of time before the sale
  - Options: Disclosures provided prior to exercise
  - RSUs/Restricted Stock: Disclosures provided prior to grant



## Rule 701 – Required Disclosure

- If sales exceed \$5 million in any 12-month period, disclosure must be provided to all investors in that 12-month period
  - “Tipping Basket” concept; no exception for the portion of the sales below \$5 million
- “701 Disclosure Package” delivered to award recipients must include:
  - Description of the material terms of the plan
  - Risk factors
  - Financial statements dated within 180 days
    - ▶ Must be prepared in accordance with GAAP
      - Foreign private issuers must provide reconciliation to GAAP
    - ▶ Provide audited financial statements (including footnotes) if available
- If disclosure is not provided to all investors in the offering prior to sale – the exemption is lost for the entire offering



## Rule 701 – What if you get it wrong?

- If Rule 701 or another exemption is not available, company has violated Section 5 of the Securities Act
- Remedy for Investors – Rescission Offer
  - Offer by company to repurchase shares and unexercised equity awards – may need to be at a premium to the exercise price or FMV
  - Contingent liability if investor does not participate in repurchase
- Potential SEC enforcement action against the company and management
  - ↳ SEC Enforcement Division opened inquiries last summer into Rule 701 compliance with apparent focus on unicorns
  - ↳ 2005 SEC Enforcement Action re General Counsel of Google resulted in cease and desist order
- Reaction of investors, potential investors and underwriters to contingent liability
- Risk factor disclosure and financial statement disclosure



## Practical Tips

- Monitor aggregate year-to-date “sales” of equity awards – generally at each time that awards are to be granted
  - Systematic calculation and confirmation becomes more critical as valuation increases and hiring ramps up as company grows (\$5 million threshold can be crossed quickly at higher valuations)
- Engage with legal counsel on all equity grants – counsel can help monitor compliance
  - If you think you are close to the \$5 million threshold or have never thought of Rule 701 before today – call legal counsel asap
- Consider whether grants to certain persons (e.g. officers, directors, accredited investors) can be made outside of Rule 701
  - Keep records to substantiate exemption
- Ensure GAAP financials will be available once \$5 million threshold is crossed



## Practical Tips

- If company grants RSUs or Restricted Stock Awards – 701 Disclosure Package is due prior to grant → company may defer new hire grants until employee has been with the company for some period
- Discuss options for delivery with counsel
  - Delivery of 701 Disclosure Package may be by secure, password-protected website
- Award recipients may be asked to sign confidentiality agreements prior to viewing financial information
  - Consider whether proprietary information agreement with employees is sufficient





*Thank you!*

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