

# Thanksgiving 701 and S-8 Revisions: Tasty Treats and a Turducken

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Just before Thanksgiving, the SEC proposed two sets of amendments to Rule 701, which provides an exemption from registration under Section 5 of the Securities Act of 1933, as amended (the “1933 Act”), for certain compensatory equity offerings, and to Form S-8, which offers a simplified method for a company registered under Section 12 of the Securities Exchange Act of 1934, as amended (the “1934 Act”), to register compensatory offerings under the 1933 Act.

One proposal addresses a number of mechanical issues that the current rules present for issuers, while simultaneously broadening the scope of the Rule 701 exemption for some issuers and simplifying the use of Form S-8, including with respect to the registration of additional securities. Issuers should perceive these proposals as they would the traditional apple, mince and pumpkin pies following the Thanksgiving feast—tasty treats that bring a smile to the face.

The second proposal creates a path for allowing finite awards of equity to be issued under Rule 701 or pursuant to Form S-8 to so-called “platform workers” providing bona fide services to issuers through an internet-based platform. This platform worker proposal seems more akin to a turducken—a turkey stuffed with a duck stuffed with a chicken—an offering that is interesting and different but that may actually appeal to a limited audience.

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## Longstanding Issues Addressed

### Former Employees of Acquired Entities

One problematic issue that has plagued issuers under both Form S-8 and Rule 701 is that, as currently in effect, each is only available with regard to equity awards issued to persons who are employees of the issuer, its parent company or a majority-owned subsidiary of the issuer or its parent at the time of issuance of the underlying equity

award.<sup>1</sup> In the context of an acquisition, this has meant that the acquirer could not use Rule 701 or Form S-8 to issue substitute awards to former employees of the acquired entity who still held compensatory awards (e.g., outstanding stock options) in respect of the acquired entity's stock. This was because these former employees were never employees of the issuer or a related entity at the time the award was issued.

The proposed revisions would rectify this problem by allowing issuances to the acquired entity's former employees in reliance on Rule 701 or Form S-8, as applicable, so long as the compensatory equity award that they held at the time of the acquisition was properly issued in reliance on such Rule or Form.

### **How to Register Shares Issuable Under a Defined Contribution Plan on Form S-8**

Another longstanding and perplexing issue for issuers who offer employer stock as an investment option under their defined contribution plans, such as a 401(k) plan, in reliance on Form S-8 has been how to determine what amount of shares to register on the Form. Under most such plans, participating employees can, in theory, transfer the entirety of their account balances into an investment in the employer on a daily basis, meaning that a staggering amount of such employer stock was "offered for sale" daily. Yet, as a practical matter, the number of shares of stock actually purchased pursuant to such an offer was just a very small percentage of what could be purchased. But even when counting just the actual purchases expected, projecting the number of shares to be purchased has been at best a task of informed speculation, as that number varies based on many factors, including the number of plan participants (which can fluctuate materially in the context of acquisitions or divestitures), participants' appetite for investing in the stock, the level of contributions and what happens to the stock price over the period of the offering.

The proposed revisions would rectify this problem by allowing the registration of an indeterminable number of shares, with the registration fee associated with the number of shares actually sold to be paid annually, in arrears, following the end of the issuer's fiscal year when it knows the number of shares that were actually purchased pursuant to the plan during such year. The retroactive fee would be required to be paid within 90 days following the end of the issuer's fiscal year by a post-effective amendment to the Form S-8.

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<sup>1</sup> The proposal also eliminates the requirement that a subsidiary of the issuer or its parent be majority-owned in order for the subsidiary's employees to be eligible to participate in a Rule 701 offering. If adopted, this would align Rule 701 with Form S-8, which is available for plans of all issuer subsidiaries regardless of the level of issuer ownership.

## The Retroactive Disclosure Dilemma Under Rule 701

A logistical dilemma for an issuer making a potentially sizable offering in reliance on Rule 701 has been how to comply with the requirement that certain financial disclosure must be provided *to all persons participating in the offering* if the aggregate sales in reliance on Rule 701 in any 12-month period exceeds \$10 million. As currently in effect, if this threshold is exceeded, all persons receiving offers to purchase must be given the requisite disclosure prior to making a purchase decision, including those acting before such limit is exceeded. Thus, as a practical matter, compliance with this requirement can only be assured if the offering is capped below this dollar limit, or the disclosure is given to all offerees in the event the limit is eventually exceeded. This issue can be particularly problematic when offers of stock options and other securities are made during the same 12-month period as Rule 701 counts options against this limit based on the date of grant, but an issuer will usually not know for many years—after the requisite vesting periods are satisfied and the option term has expired—whether sales that would exceed this limit will actually occur.

The proposed revisions would address this issue by limiting the requirement to provide the additional disclosure only in respect of sales occurring after the \$10 million has been exceeded.

## Alternative Means of Satisfying the Additional Disclosure Requirements

If the \$10 million threshold is exceeded, Rule 701 currently requires the delivery of financial information about the issuer of the type and nature required by Part F/S of Form 1-A. Under the currently effective rule, such financial information may not be more than 180 days old, which can mean as a practical matter that the financial statements must be prepared quarterly to satisfy this requirement. For some private issuers, because such financial information is not otherwise widely disseminated, they are reluctant to share such information with the employees eligible to participate in a compensatory offering under Rule 701, which can be significant. For a foreign issuer, if its financial statements are not prepared in accordance with either U.S. GAAP or IFRS, the required disclosure must be reconciled to U.S. GAAP, even if the issuer provides financial disclosure under the rules of its home country, and its stock is traded on a foreign stock exchange.

The proposed revisions would address these matters in a number of ways. To allow the use of semi-annual financial statements, the proposed revisions would allow the use of financial statements that are not more than 270 days old. The revisions would allow any foreign private issuer that is exempt from the registration requirements under Section 12 of the 1934 Act pursuant to Rule 12g-3-2(b) to satisfy the disclosure requirements by providing financial statements prepared in accordance with the rules of its home country, if financial statements reconciled to U.S. GAAP or IFRS are otherwise not

available, or by providing the fair market value of the securities to be sold, as determined in a manner consistent with the requirements of Section 409A of the Internal Revenue Code of 1986, as amended, applicable to stock readily tradeable on an established securities market. Additionally, the proposed revisions would allow any issuer relying on Rule 701 to substitute a valuation report prepared by an independent appraiser in a manner consistent with the requirements for such a report under such Section 409A, in lieu of providing the requisite financial information.

### **Permitting Services Through Entities**

Both Rule 701 and Form S-8 are currently applicable to consultants and advisors (in addition to employees) who are natural persons. This can deny the availability of the Rule 701 exemption or prevent the use of Form S-8 to provide equity-based compensatory arrangements for persons who provide services through an entity that is not wholly-owned.

The proposed revisions would address this issue by allowing the services to be performed through an entity, so long as substantially all of the activities of such entity involve the performance of services and substantially all of the ownership interests of the entity are held directly by no more than 25 natural persons, at least 50 percent of whom perform such services for the issuer through the entity or by the estate or death beneficiaries of such natural persons.

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## **Rule 701 Expansions and Form S-8 Simplification**

### **Increase in Dollar Limit and Asset Limits Applicable Under Rule 701**

Currently, the maximum amount of securities that may be offered in reliance on Rule 701 is the greatest of three alternative measurements: (i) 15% of the class of securities being offered; (ii) an amount equal to the value of 15% of the issuer's assets (or, if the offering is guaranteed by the issuer's parent, 15% of the value of the issuer's parent's assets) and (iii) \$1 million. The proposed revisions would increase the floor amount that could be offered in reliance on Rule 701 to \$2 million and would also increase the percentage of assets that may be considered to set the value threshold related to the issuer's assets (or the assets of the issuer's parent) from 15% to 25%. The revisions do not change the percentage of the class of equity that can be offered in reliance on Rule 701.

### **Registering Additional Shares by Post-Effective Amendment, Clarifying That Plans Can Be Added to Existing Registration Statements and Allocating Shares Among Incentive Plans**

Perhaps most significantly, the proposal would allow additional shares to be added to an existing Form S-8 registration statement by a post-effective amendment, rather than requiring that a new registration statement be filed to add to the shares available under a compensatory offering. The proposed revisions would explicitly also state that additional compensatory plans may be added to an existing Form S-8 registration statement. For example, if a new equity incentive plan is adopted and the shares previously available under the prior plan are rolled over into the new plan, the proposed revisions confirm expressly that the new plan can be added to the existing registration statement covering such shares. The proposed revisions would also confirm expressly that a Form S-8 registration statement can allocate the shares registered under a single registration statement among the multiple plans covered by such registration statement.

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## **The Platform Workers Programs**

Under the second set of proposed amendments, Rule 701 would be modified to add an additional exemption for, and Form S-8 would be amended expressly to permit registration of, equity interests offered pursuant to a written compensatory benefit plan or contract for platform workers if the applicable conditions are satisfied. While it might be possible under the existing rules to offer securities to such platform workers in reliance on the currently applicable provisions of Rule 701 or Form S-8, in the proposing release, the SEC noted that such workers have greater flexibility in determining when and how much they work, that their relationships can be on a short-term, part-time, or freelance basis and that they may have similar relationships with multiple companies through which the individual may engage in the same or different business activities. For these reasons, such workers might not be employees, consultants, advisors, or de-facto employees eligible to receive securities in compensatory arrangements under the current provisions of Rule 701 or Form S-8.

The conditions to the Rule 701 exemption or the utilization of Form S-8 for a platform worker program impose relatively restrictive limits on the amount of securities that may be offered pursuant to the program and mandate regular periodic disclosure to the Commission that may limit the efficacy or appeal of the opportunity provided by this proposal. In all events, as proposed, this exemption (or right to register using Form S-8) would generally only apply to offers or sales of securities occurring prior to five years following the date the revisions become effective, although offers commenced in compliance with such provisions prior to such expiration could be completed. SEC action would be required to extend the modifications beyond that five year period.

## Definition of Platform Worker and Control of the Platform

A platform worker is a natural person (or a qualifying entity, as described below) unaffiliated with the issuer who provides (i) *bona fide* services to the issuer, its parent company or a subsidiary of either of the issuer or its parent (which under the proposed rule no longer needs to be a majority-owned subsidiary) or to third-party end-users for the benefit of the issuer; (ii) pursuant to a written contract or agreement; and (iii) through an internet-based platform or other widespread, technology-based marketplace platform or system that the issuer operates and controls. The SEC stated in the proposing release that a platform worker could provide services “to end users, such as ride-sharing, food delivery, household repairs, dog-sitting, or tech support, or using the platform to sell goods or lease property to third parties.” However, selling or transferring permanent ownership of discrete, tangible goods would not constitute *bona fide* services for purposes of these provisions.

A platform worker may be an entity if (i) substantially all of its activities involve the performance of *bona fide* services that meet the otherwise applicable requirements of these provisions, and (ii) the ownership interests in the entity are wholly and directly held by the natural person performing such services. An issuer will be deemed in control of the platform if it (i) provides access to the platform and establishes the principal terms of service for using the platform; (ii) establishes the terms and conditions by which the platform worker receives payment for the services provided through the platform; and (iii) can accept and remove the platform worker. Consistent with the generally applicable requirements under Rule 701 and the conditions to using Form S-8, the exemption under Rule 701 or the ability to use a Form S-8 will not be available for a platform worker program if the services rendered by the platform worker are in connection with the offer or sale of securities in a capital-raising transaction or services that directly or indirectly promote or maintain a market for the issuer's securities.

## Limitations on the Value of Securities That Can Be Provided and Other Conditions

There are, however, significant restrictions on the scope of the applicable exemption or ability to utilize Form S-8. The amount and terms of any securities issued to a platform worker may not be subject to individual bargaining or the worker's ability to elect between payment in securities or cash. Under the platform worker program, no more than 15 percent of the value of compensation received by a platform worker from the issuer for services provided during a consecutive 12-month period, and no more than \$75,000 of the value of compensation received by the platform worker from the issuer during a consecutive 36-month period, may consist of securities. Such value would be determined at the time the securities are granted using methodologies otherwise applicable for purposes of Rule 701. Moreover, to the extent the offer and sale occurs in reliance on the Rule 701 exemption, the issuer must take reasonable steps to prohibit

the transfer of the securities issued to a platform worker pursuant to this exemption, other than a transfer to the issuer or by operation of law, except that such securities may be resold 90 days after the issuer becomes subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act.

### **Requirement of Periodic Disclosure to the SEC**

Additionally, an issuer relying on these provisions in respect of a platform worker program is required to furnish the following information to the Commission (in such manner as it shall specify) at six-month intervals commencing six months after the first issuance to a platform worker:

- The criteria used to determine eligibility for securities awards to platform workers, whether they are the same as for other compensatory transactions and whether those criteria, including revisions to the criteria, are communicated to workers in advance as an incentive;
- The type and terms of securities issued to platform workers during each six-month interval and whether they are the same as for other compensatory transactions by the issuer during that interval;
- With regard to an offering effected in reliance on Rule 701, the reasonable steps taken to prohibit the transfer of the securities sold pursuant to these provisions;
- The percentage of outstanding securities represented by the amount of securities issued cumulatively in reliance on these provisions;
- During each six-month interval, information regarding the number of platform workers generally and the number participating pursuant to these provisions plus, (i) with regard to the Rule 701 exemption, the number of non-platform workers who received securities in accordance with Rule 701 and (ii) with regard to Form S-8, the number of participating platform workers relative to the other persons eligible to receive securities pursuant to the Form S-8 registration statement; and
- The number and dollar amount of securities issued to platform workers in each six-month interval, both in absolute amounts and as a percentage of the issuer's total sales in reliance on Rule 701 or pursuant to Form S-8, as applicable.

The issuer may request confidential treatment for such information.

Please do not hesitate to contact us with any questions.

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