

CLIENT ALERT

SEC Amends Rule 701 to Increase from \$5 Million to \$10 Million the Threshold for the Requirement to Deliver Additional Disclosures to Investors

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Effective July 23, 2018, the Securities and Exchange Commission (the “SEC”) amended Rule 701 under the Securities Act of 1933 (the “Securities Act”), which provides an exemption from registration for securities issued by non-reporting companies pursuant to compensatory arrangements.¹ As mandated by the Economic Growth, Regulatory Relief and Consumer Protection Act, the amendment increases from \$5 million to \$10 million, the aggregate 12-month sales threshold in Rule 701(e) in excess of which the issuer is required to deliver additional disclosures to investors.

In addition, in a Concept Release² the SEC is soliciting comment on possible ways to modernize and simplify the rules related to compensatory arrangements in light of the significant evolution in both the types of compensatory offerings and the composition of the workforce. The public comment period will remain open for 60 days.

Background

Often used by private companies, Rule 701 provides an exemption from registration under the Securities Act for offers and sales under a written compensatory benefit plan or a written compensatory contract established by the issuer of the securities, its parents, its majority-owned subsidiaries, or majority-owned subsidiaries of the issuer’s parent for the

¹ See SEC Release No 33-10520, available [here](#).

² See SEC Release No. 33-10521, available [here](#).

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participation of their employees, directors, general partners, trustees, officers, consultants, and advisors who are natural persons (and their family members through gifts or domestic relations orders). Thus, an offeree or purchaser must be one of these persons at the time of the offer or sale for Rule 701 to apply. Rule 701 is only available for private companies that are not subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934. In all cases, the issuer must deliver to each potential purchaser a copy of the compensatory benefit plan or compensatory contract, as applicable.

Issuance Limitations

In addition to the requirements described above, the aggregate sales price of all securities sold during any consecutive 12-month period in reliance on Rule 701 may not exceed the greatest of (i) \$1,000,000, (ii) 15% of the total assets of the issuer (including its parent if the issuer is a wholly owned subsidiary of the parent and the parent fully and unconditionally guarantees the securities being issued), and (iii) 15% of the outstanding amount of the class of securities being offered and sold in reliance on Rule 701. Clause (ii) would allow private companies with significant assets, or with parent companies having such assets, to make sizable exempt issuances of securities under Rule 701.

Additional Disclosure Threshold

However, there is another applicable limit in Rule 701. In addition to the limits discussed above, Rule 701(e) provides that if the aggregate sales price of all securities sold during any consecutive 12-month period in reliance on Rule 701 exceeds a certain amount, previously \$5 million and now \$10 million, the issuer must deliver to the investors in a reasonable period of time before the actual sale date the following disclosure: (i) a summary of the material terms of the plan; (ii) information about the risks associated with investment in the securities to be sold; (iii) financial statements dated no earlier than 180 days before the sale date, which for foreign private issuers must include a reconciliation to U.S. GAAP if their financial statements are not prepared in accordance with U.S. GAAP or International Financial Reporting Standards as issued by the IASB; and (iv) if the issuer is relying on the aggregate sales price limit defined as 15% of the total assets of the issuer and is including its parent's assets as a wholly owned subsidiary of the parent to determine the amount of securities that may be sold, the parent's financial statements.

As a practical matter, these additional disclosure requirements have acted to limit the issuances or sales of securities of private companies pursuant to Rule 701 to \$5 million a year. The SEC has, effective July 23, 2018, raised that limit to \$10 million.

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If you have any questions regarding this client alert, please contact the following attorney or the attorney with whom you regularly work.

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