SECURITIES REGISTRATION

Is It Time to Retire Form S-8?

Securities Act registration of interests in employee benefit plans has become more of a compliance exercise than a way to protect employee investors. It may be time to explore a different approach that can reduce the burdens while still providing investor protection.

By Keith F. Higgins

Every securities lawyer knows as a bedrock principle that all offers and sales of securities must either be registered under the Securities Act of 1933 (Securities Act) or made pursuant to an applicable exemption. This notion is so fundamental that we often neglect to think about its purpose—namely, investor protection. We spend countless hours analyzing whether some instrument or another is a security and, if it is, whether an offer or sale is taking place. These are often difficult questions, to be sure, but I often wonder whether we approach them more as intellectual explorations into the metaphysics of the Securities Act rather than keeping our eye on the investor protection ball. Nowhere is that more true than with securities "offered and sold" under employee benefit plans.

Providing equity to employees[1] is an important benefit. Indeed, in some sectors such as technology, it is considered essential to attracting and retaining the most talented employees. The instruments used to convey these equity interests are almost always securities for purposes of the Securities Act. Although frequently they are provided in such a way that does not involve a "sale," there are instances in which the securities are sold and therefore employers need either to register the offer and sale under the Securities Act or have an applicable exemption.

These offers and sales are fundamentally different from those that are made in connection with a company's capital-raising activities. To begin with, as a general matter their purpose is compensatory, and they represent an element of an employee's total compensation package. The most common forms of compensatory awards—stock options, restricted stock or restricted stock units (RSUs)—are granted without any particular bargained for consideration on the part of the employee. These awards typically include vesting requirements based on continued service or, increasingly, company performance criteria. The employee usually would not pay anything for the stock option, restricted stock or RSU. In the case of stock options, the issuance of stock upon the payment of the exercise price of the option is certainly a sale. When the company's stock is publicly traded, the option will only be exercised if the option is "in the money" at the time of exercise and it is frequently the case that the employee engages in a same-day sale to capture the spread on that date. Thus, although there is some element of an investment decision in compensatory transactions, they represent different risks to the purchaser than when a company is engaged in raising capital. Moreover, companies have a different relationship with their employees than they do with their investors and hence may have less reluctance to be open and transparent with their employees. Companies also have a keen interest in making sure they have satisfied employees.

Recognizing the different risk and the fact that employees have a relationship to the company providing some measure of access to information, the Securities and Exchange Commission has provided exemptions and simplified registration for compensatory transactions with employees.

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Rule 701

For companies that are not reporting companies under the Securities Exchange Act of 1934 (Exchange Act), the Commission has provided an exemption under Rule 701 under the Securities Act for offers and sales of securities under a written compensatory benefit plan. Under Rule 701, a company can sell during any consecutive 12-month period up to 15 percent of the outstanding amount of the class of securities it is offering[2] to employees.[3] The Rule 701 exemption requires that the company deliver to each recipient of the securities a copy of the written plan under which the securities are being delivered. So long as the amount sold does not exceed $5 million in any period of 12 consecutive months, that written plan is all that must be delivered.

The theory behind relieving the company of any obligation to deliver company-specific information is the notion that an employee's relationship to the company permits him or her access to any necessary information and to assess the appropriateness of an investment in the company's securities. At least that is—or surely must be—the theory. If sales exceed $5 million in any 12-month period, however, the company also must deliver, a reasonable period of time before the sale, a summary of the material terms of the plan (or, if it is an ERISA plan, the summary plan description), information about the risks associated with investment in the securities, and financial statements meeting the requirements of Regulation A under the Securities Act.[4] Although the securities an employee receives under the Rule 701 exemption are "restricted securities" for Securities Act purposes, once the company has been subject to the reporting requirements under the Exchange Act for 90 days, the securities may be resold in compliance with the manner-of-sale and volume limitations of Rule 144 under the Securities Act.[5]

Form S-8

A Brief History

Once a company is publicly reporting, Rule 701 is no longer available for new grants of compensatory awards. As a practical matter, the only way for a public company to offer and sell employer securities broadly to employees is by filing a registration statement under the Securities Act on Form S-8[6] and complying with the requirements applicable to offerings conducted on that form. A little history provides some context. Prior to 1953, offers and sales to employees needed to be registered on Form S-1. Then, in 1953, the Commission adopted Form S-8 specifically for employee stock purchase plans.[7] The form required the filing of a short prospectus and certified financial statements. Companies also were required to deliver a copy of their annual report to all participating employees and any other materials it distributed from time to time to shareholders. Registration statements on Form S-8 were required to be declared effective.

All Forms S-8 and post-effective amendments became effective automatically upon filing.

In 1980, the Commission revised the rules to allow these registration statements to go effective automatically—although even then effectiveness for the original registration occurred only 20 days after filing, while post-effective amendments were effective upon filing.[8] Later that same year, the Commission adopted amendments that streamlined the disclosures required by Form S-8 and allowed companies to update the registration statement through required incorporation by reference of their Exchange Act filings.[9]

In 1990, the Commission took a big step in making Form S-8 simpler. In that year, the form took essentially the shape that is has today.[10] The prospectus was physically moved out of the registration statement and the company was allowed to use any documents it wished to satisfy the prospectus requirement. These documents were required to bear a legend letting the recipient know that they were part of a prospectus under the Securities Act. All Forms S-8 and post-effective amendments became effective automatically upon filing. The process was

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put in place by which a company could file a registration statement to register additional shares and incorporate by reference the contents of an earlier registration statement.

Costs and Benefits

As streamlined and easy to use as Form S-8 has become since 1990, there are still compliance costs associated with preparing and administering it for offerings of securities to employees. The form itself must be prepared and signed by the principal executive officer, the principal financial officer, the principal accounting officer and a majority of the directors then in office. A registration fee must be paid at the time of the filing. A legal opinion on the legality of the securities being offered must be included, as must the consent of any auditors whose reports are being incorporated by reference into the filing. Companies can minimize the expense associated with the auditor's consent by trying to arrange to make the filing at or around the time its Form 10-K is being filed, but that is not always possible. Although the prospectus requirements are flexible and allow companies the ability to use documents that they otherwise prepare and distribute in connection with their benefit programs, they nonetheless must be labeled and tracked as part of the company's compliance efforts.[11] The number of shares sold under the Form S-8 also must be tracked carefully lest the company find itself having sold shares in excess of the amount registered. For offerings involving stock options, restricted stock or RSUs, tracking the shares is not too difficult, but that is not the case for 401(k) plans that offer a company stock fund as an investment alternative, particularly where shares to satisfy employee elections are acquired by the trustee on the open market.

Let's turn to the potential benefit that Form S-8 provides to the employees receiving securities in a registered offering. The Securities Act is a disclosure statute and registration makes information about the company and the transaction available to offerees and purchasers. The materials that constitute the prospectus—except for the incorporated Exchange Act filings—are essentially what the company makes available to its employees in the ordinary course of administering its compensatory benefit programs. The Exchange Act filings that provide information about the company are incorporated into the S-8 prospectus and are readily available at the click of a mouse. From an information standpoint, therefore, it is difficult to think of anything that Form S-8 requires a company to provide to the employee that is not either already being provided or readily available.[12]

The number of shares sold under the Form S-8 also must be tracked carefully lest the company find itself having sold shares in excess of the amount registered.

The Securities Act also provides investors with protection by making issuers liable for material misstatements and omissions in offering documents. This liability regime applies to offerings conducted on Form S-8 and thus provides a potential benefit to the employee acquiring securities. Under Section 11, the company has strict liability for any material misstatements or omissions in the registration statement at the time it became effective. In addition, under Section 12(a)(2), the materials that constituted the prospectus would provide a basis for company liability if they contained any material misstatements or omissions.[13] In the public markets in connection with securities offerings, these two provisions have provided the basis for countless claims brought against issuers and sellers of securities. Has the same been true for sales of securities under compensatory benefit programs?

We searched the database of reported cases to find any that involved private litigation alleging Securities Act liability as a result of offers and sales to employees using Form S-8. We found three such cases. Two of them were brought as class actions by employees and former employees of Enron Corporation who

acquired shares of common stock that had been registered on Form S-8 upon the exercise of Enron stock options.[14] In the most recently decided case, in which the court granted the defendant's motion to dismiss, a broker-dealer that had been hired to administer the Enron stock option program was alleged to have been an underwriter of Enron common stock for Section 11 purposes and a seller of the securities for Section 12(a)(2) purposes. Although the court recognized that there were material omissions in Enron's Exchange Act filings, the named plaintiffs had received stock options in connection with their employment, which the court found not to involve a sale, and none of the named plaintiffs had exercised any of the options and thus there was no sale. In an earlier case, the court denied the defendant broker-dealer's motion to dismiss, finding that the plaintiffs had alleged sufficiently that the broker-dealer was a statutory underwriter under Section 11 and a seller under Section 12(a)(2) in connection with its administration of Enron's employee stock option program.

Private rights of action under the Securities Act are not terribly valuable to employees.

The only other reported case we found involved a purported class consisting of purchasers of Compaq Computer Corporation common stock and options in the open market and of purchasers of common stock either pursuant to or traceable to two Form S-8 registration statements. That case was disposed of on a motion to dismiss, with the court finding that the misleading statements in question that had been incorporated into the Form S-8 prospectus were forward-looking statements that were "corporate puffery" and therefore not material.[15] Even if the statements had been material, the court found they would have been protected by the safe harbor for forward-looking statements.

Although there have been few private actions involving Form S-8, there have been Commission enforcement actions involving the use of the form or, to state it better, its misuse. These cases typically involved companies that used Form S-8 to register offers and sales of securities to so-called "consultants," and used the funds to pay company operating expenses and creditors, while the consultants distributed the shares to the public.[16] This misuse of the form led the Commission in 1999 to adopt amendments making clear that Form S-8 was not available for consultants or advisors who directly or indirectly promote or maintain a market for the company's securities.[17] Form S-8 provided no measure of investor protection in those instances, as the claims were that the form was not available for those types of transactions.

Counting the number of private actions brought in connection with a Form S-8 registration is admittedly an imprecise way to gauge whether Securities Act registration of compensatory benefit transactions is providing any investor protection. Bringing suit against one's employer is not a terrific strategy for job longevity and would likely only be used in the event of a company meltdown (e.g., Enron). But even accepting that, it seems to be some indication that the private rights of action under the Securities Act are not terribly valuable to employees. Securities Act registration also exists for the purpose of getting information to purchasers but, as we have seen, the information that employees receive as a result of registration is largely information that they would otherwise get or to which they have ready access. Although it is certainly the case that in the typical capital-raising situation the Securities Act registration statement provides a discipline around the review of information that is part of the registration statement and prospectus, it is unlikely that Form S-8 independently serves that function.[18]

An Alternative to Form S-8: Extend the Rule 701 Exemption to Public Companies

There may be a way to cut down on the cost of compliance without sacrificing investor protection. If Rule 701 is an appropriate exemption by which

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private companies can offer and sell securities to their employees, it seems as appropriate to make a similar exemption available for public companies. Indeed, it seems anomalous that a private company that is not required to make financial and operating information generally available can sell up to $5 million of it securities broadly to all its employees without providing *any* information, while a public company cannot do so without registering the offer and sale on Form S-8.[19] Although the Securities Act provisions for civil liability would not be available for Rule 701 transactions, employees always would have Rule 10b-5 for cases of fraud. Moreover, compensatory transactions with employees present an extremely low risk of fraud.[20] Requiring registration for the sole purpose of preserving Securities Act liability against the possibility of misstatements or omissions seems to be overkill.[21]

What might such an exemption look like? First, it would only be available "for securities issued in compensatory circumstances … [and not] for plans or schemes to circumvent this purpose," which the text of Rule 701 currently provides. If the exemption were made available to public companies (*i.e.,* companies with a class of securities registered under Section 12 of the Exchange Act or who report under Section 15(d) of the Exchange Act), its availability could be limited to companies that were current in their Exchange Act filings. Such a requirement seems fair and not overly burdensome, and there is at least a substantial question under Form S-8 whether a company should continue offering securities when it is delinquent in its Exchange Act filings. Second, Rule 701 has limitations on amounts that may be sold under this exemption, as well as a minimum amount, and some form of limitations could apply to public companies as well. They need not necessarily be those that apply to private companies. If, however, the 15 percent of the outstanding amount of the class of securities that is being sold limitation were to apply, given the focus of institutional investors and proxy advisory firms on equity burn rates, it is unlikely that any company would find that limitation in any way too restrictive. Third, as for information, because of the easy availability of Exchange Act filings, there should be no need to apply the disclosure requirements of Rule 701(e) to sales by public companies, although a requirement to provide a summary of the material terms of the plan or, in the case of ERISA plans, the summary plan description would not be burdensome. There would be no need to require that financial statements be provided to employees, as that information is readily available in the company's Exchange Act filings. If it were determined that there were specific risks applicable to an offering to employees, imposing such a requirement would not be problematic.

An exemption that applied to public companies would have to address how employees receiving securities could resell them.

Both Rule 701 and Form S-8 are available for offers and sales not only to traditional, common law employees but also to "consultants and advisors." This expansion beyond traditional employees was intended to recognize that other service providers can have a relationship with a company that justifies a lighter regulatory touch when dealing with bona fide compensatory arrangements. What qualifies someone as a "consultant" or "advisor" is not always clear, and the Commission and the staff have provided guidance on this subject over the years. This guidance likely in is need of a fresh look, particularly in light of the different forms of work in what has become known as the "gig economy." That task probably needs to be undertaken in any event, and re-thinking Form S-8 could be an occasion to undertake that effort.[22]

Securities sold in reliance on Rule 701 are "restricted securities" for Securities Act purposes. That is not the case with securities that are sold in transactions registered on Form S-8, which are freely tradeable, subject to any restrictions on

affiliates. An exemption that applied to public companies would have to address how employees receiving securities could resell them. Under the current exemption, if the company has been publicly reporting for at least 90 days, securities issued in reliance on Rule 701 may be resold under Rule 144 without complying with the current public information and holding period requirements. The 90-day wait only applies to resales, however, and there should be no reason why a company could not make awards immediately upon becoming subject to Exchange Act registration.[23] In any event, these are details that could be worked out in expanding the Rule 701 exemption.

There is, of course, the issue of the registration fees paid on Form S-8, which do not apply to exempt transactions under Rule 701. During calendar year 2016, a little more than $30 million was paid in fees for registrations on Form S-8, which represented approximately 6 percent of all registration fees paid that year and a little less than 2 percent of the agency's budget. Losing those fees would be part of the reduced compliance burdens associated with no longer requiring companies to use Form S-8. But the reduced fee revenue is something that the Commission would have to consider if it decided to pursue this alternative.

Conclusion

Had the Securities Act provided the Commission with broad exemptive authority from the outset, perhaps an exemption for employee compensatory arrangements would have been implemented early on. Although the registration process for employee benefit plans has been much streamlined over the years, requiring its use in connection with bona fide compensatory arrangements with employees seems to be little more than a pure compliance exercise without providing any real benefit to the recipients of the securities. Expanding the availability of Rule 701 to public companies could be part of the Commission's agenda to make it more attractive to be a public company.

Notes

1. This article uses the term "employee" as a shorthand for "employees, directors, general partners, trustees (where the issuer is a business trust), officers, or consultants or advisors," which is the group covered by the registration form and the exemption.
2. The company can in all events sell up to $1 million of securities, even if it exceeds the 15-percent limit.
3. Also included are family members who acquire the securities through gifts or domestic relations orders.
4. The analytical basis for distinguishing below and above $5 million isn't clear. As originally adopted, the rule had a hard limit of $5 million. That limit derived from Section 3(b) of the Securities Act, on which the exemption was based. In 1999, several years after the National Securities Markets Improvement Act of 1996 in which Congress gave the Commission the authority to provide exemptive relief in excess of $5 million.
5. The manner-of-sale requirements are that the transaction must either be a brokers' transaction, a riskless principal transaction or directly to a market maker. The volume limitations are the greater of 1 percent of the outstanding shares or the average weekly trading volume for the four weeks prior to the week in which the sale is taking place. For employees who are not "affiliates," restricted securities can be sold after a six-month holding period if the company is public and current public information is available, or at any time after a one-year holding period even if the company is not publicly reporting.
6. There are, of course, other alternatives such as filing a Form S-1 or Form S-3 or possibly using an exemption under Regulation D or Regulation S under the Securities Act.
7. SEC Release No. 33-3849 (June 16, 1953).
8. SEC Release No. 33-6190 (Feb. 22, 1980).
9. Sec Release No. 33-6202 (Apr. 2, 1980).
10. SEC Release No. 33-6867 (June 6, 1990).
11. Under Rule 428 under the Securities Act, documents that constitute the prospectus must bear a legend indicating that they are part of a prospectus covering securities that have been registered under the Securities Act.
12. Although Rule 428(b) specifies various documents that a company must deliver to employees participating in

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an employee benefit plan, none of them are documents that are not readily available either through the SEC's EDGAR system or on a company's website.

13. The company would have a defense if it "did not know, and in the exercise of reasonable care could not have known, of [the] untruth or omission."
14. *Lampkin v. UBS Painewebber, Inc. (In re Enron Corp. Sec., Derivative & "ERISA" Litig.),* 2017 U.S. Dist. LEXIS 28458 (S.D. Tex., Feb. 28, 2017) and *Newby v. Enron Corp.* (*In re Enron Corp. Secs.*), 2003 U.S.Dist. LEXIS 25037 (S.D. Tex., Nov. 13, 2003).
15. *Kurtzman v. Compaq Computer Corp.*, 2002 U.S. Dist LEXIS 26569 (S.D. Tex., Mar. 30, 2002).
16. *See, e.g.,* Securities and Exchange Commission v. Hollywood Trenz, Inc., Edward R. Showalter, Tracy A. Braime, and Robert E. Burton, Jr., Civil Action No. 98-1106 (RMU) (D.D.C. May 4, 1998). *See also* In the Matter of Steven M. Scarano, CPA (Administrative Proceeding File No. 9-9694, Sept. 9, 1998) and In the Matter of Alexander & Wade, Inc. and James Y. Lee (Administrative Proceeding File No. 3-13123, Aug. 7, 2008).
17. SEC Release No. 33-7646 (Feb. 25, 1999).
18. In 35 years of law practice, the author can never remember reviewing a company's Exchange Act filings incorporated by reference into a Form S-8 as of the time that registration statement became effective. For those documents, the requirements for disclosure controls and procedures and the certifications required by the Sarbanes-Oxley Act provide a greater measure of discipline.
19. The public company could, of course, rely on an exemption such Section 4(a)(2) under the Securities Act or Rule 506, or perhaps even do an offering under Regulation A. Those are unlikely to be very attractive alternatives for a variety of reasons.
20. One type of compensatory transaction that could give rise to some measure of concern is when companies set up non-qualified deferred compensation arrangements in which employees defer compensation to which they are otherwise entitled to be paid out at a later time and are permitted to choose "investment" alternatives by which those amounts can grow. The employee is relying on the creditworthiness of the company at the time the payment is due and in that sense is truly investing in the company.
21. It is true that Form S-8 itself has been used by some unscrupulous companies to engage in fraudulent schemes with sales to so-called "consultants." See, e.g., SEC v. Hollywood Trenz, Inc., et. al. (Litigation Release No. 17204 (Oct. 25, 2001) and SEC v. Softpoint, Inc., 958 F. Supp. 846 (S.D.N.Y. 1997). So long as the Rule 701 exemption is only available to *bona fide* compensatory transactions, those schemes would still be subject to enforcement action and civil liability.
22. Other aspects of how Rule 701 works for private companies that are in need of a fresh look include whether $5 million is the right threshold for when information must be provided, the difficulty in predicting during a year when that threshold will be met and when information must be delivered in connection with RSU awards.
23. Under the existing rules, many companies file one or more Forms S-8 on the day they become subject to Exchange Act registration.