December 7, 2020

SEC Proposes Amendments to Modernize Rule 701 and Form S-8 for Compensatory Securities Offerings and Sales Including Temporary Eligibility for Certain Internet-Based "Platform Workers"

On November 24, 2020, the U.S. Securities and Exchange Commission (SEC) voted to propose amendments to Rule 701 and Form S-8 to reflect recent trends in compensatory practices, ease the administrative requirements under these two regulations, and permit (at least temporarily) grants of equity-based incentives to certain workers in the "gig economy." The companion releases (Release Nos. 33-10891 and 33-10892) signify the SEC's first substantive changes in years to the two principal means by which issuers grant securities to employees in compensatory transactions.[1] If adopted, the amendments would lower the compliance and disclosure costs to non-reporting issuers that rely on, or seek to rely on, the Rule 701 exemption; simplify the rules for registering securities on Form S-8; and expand the scope of participants who would be eligible to receive compensatory securities under Rule 701 or on a Form S-8 registration statement.

This Alert briefly summarizes key aspects of the SEC's rulemaking proposals. The deadline to submit comments on these rule proposals to the SEC is **no later than 60 days after the proposals' publication in the *Federal Register*.**[2]

I. BACKGROUND: SEC'S 2018 CONCEPT RELEASE

In July 2018, the SEC issued a concept release[3] seeking comments on ways to modernize the Rule 701 exemption from registration, the Form S-8 registration statement, and the relationship between these two regulations, consistent with investor protection. The concept release acknowledged the evolving landscape over the last two decades with respect to the types of compensatory offerings issuers were making as well as the changing composition of the workforce. At the same time, the concept release sought to preserve the compensatory purpose of Rule 701 and Form S-8 and prevent them from being used for capital-raising purposes.

II. RELEASE NO. 33-10891: MODERNIZATION AND HARMONIZATION OF RULE 701 AND FORM S-8

The SEC has proposed various amendments to Rule 701 and Form S-8 to address some of the administrative and compliance challenges that have burdened (and in some cases, deterred) issuers looking to engage in a compensatory securities offering. These amendments are briefly summarized below:

Rule 701
• **Revise the timing, age and form of additional disclosure required for Rule 701 exempt transactions exceeding $10 million.** o The SEC has proposed to revise Rule 701(e) to provide that, if the aggregate sales price or amount of securities sold during a consecutive 12-month period exceeds $10 million, the issuer must deliver the

[1] While the SEC amended Rule 701 in 2018 to implement the Congressional mandate to raise the Rule 701(e) disclosure threshold from $5 million to $10 million, the last substantive amendment of Rule 701 prior to then was in 1999. The SEC last substantively amended Form S-8 in 2005.

[2] As of the date of this Alert, the proposal had not been published in the *Federal Register*.

[3] Concept Release on Compensatory Securities Offerings and Sales, Release No. 33-10521 (Jul. 18, 2018) [83 FR 34958].

required additional disclosures for any sales that occur **after** the $10 million threshold has been reached, not all sales during the 12-month period as is currently the case.

- The SEC has also proposed to align the age of the additional financial statement disclosures with what is required for Regulation A offerings. In particular, financial statements would have to be available on at least a semi-annual basis and completed within three months after the end of the second and fourth quarters. Therefore, issuers would no longer be required to prepare financial statements quarterly in order for sales to be made continuously pursuant to Rule 701. In addition to Regulation A, this change would also be consistent with foreign private issuers' financial statement updating requirements for registered offerings on Form 20-F, thereby eliminating any disadvantage for non-reporting foreign private issuers.
- Furthermore, in lieu of financial statements to satisfy the Rule 701(e) disclosure, the SEC has proposed to allow issuers to provide alternative valuation information—specifically, an independent valuation report for determining the fair market value of stock not readily tradable on an established securities market in accordance with Section 409A of the Internal Revenue Code. To ensure appropriate investor protections, the valuation report would have to be prepared pursuant to an independent appraisal, and it would have to be updated at six-month intervals.

- **Revise the timing for additional disclosure for derivative securities that do not involve a decision to exercise or convert in the context of new hire grants.**
  - The SEC's view is that required disclosure for a restricted stock unit (RSU) or other award that does not involve an investment decision upon its exercise or conversion must be provided at the time of the initial award. As proposed, in connection with the grant of such an award made in connection with the hire of a new employee, the additional Rule 701(e) disclosure would be considered delivered a reasonable period of time before the date of sale if it is provided no later than 14 calendar days after the date the person begins employment.
  - According to the SEC, providing an accommodation for delivery 14 calendar days after commencing employment would provide the issuer an opportunity to address confidentiality concerns while providing the employee disclosure within an appropriate time period. In any other circumstances, the issuer would be required to deliver the disclosure a reasonable period of time before the date the RSU or a similar award is granted.

- **Raise two of the three alternative ceilings that cap the overall size of the Rule 701 offering during any consecutive 12-month period.**
  - The SEC has proposed to change the requirement that the aggregate sales price or amount of securities sold in reliance on Rule 701 during any consecutive 12-month period must not exceed the greatest of three alternative ceilings. In light of the less asset-intensive nature of contemporary businesses and the effects of inflation since the adoption of these alternatives in 1999, the following two caps would be raised:
    - the asset cap from 15% to 25% of the total assets of the issuer[4]

[4] The relevant limit applies to the total assets of the issuer's parent if the issuer is a wholly owned subsidiary and the securities represent obligations that the parent fully and unconditionally guarantees, as measured at the issuer's most recent balance sheet date (if no older than its last fiscal year end).

- the dollar cap from $1 million to $2 million

- The third alternative cap – 15% of the outstanding amount of the class of securities being offered and sold – would be retained with no changes.

- **Make the Rule 701 exemption available for offers and sales of securities by the issuer's subsidiaries, whether or not majority-owned.**
  - In an effort to harmonize Rule 701 and Form S-8, the SEC has proposed to amend Rule 701(c) by substituting the term "subsidiaries" for "majority-owned subsidiaries." Like Form S-8, Rule 701 would be available for the issuance of issuer securities to employees of its subsidiaries, without regard to whether those subsidiaries are majority-owned.
  - By broadening the exemption to include all subsidiaries, the proposal would, among other things, expand eligibility to subsidiaries consolidated by the issuer as variable interest entities, such as medical practices consolidated by the issuer. As a result, an issuer that has a controlling financial interest in such a medical practice generally would consolidate it, which would allow employees of the medical practice to become eligible as employees of the issuer's subsidiary.

Form S-8

- **Implement improvements and clarifications to simplify Form S-8.**
  - Clarify the ability to register multiple plans on a single Form S-8.
  - Clarify the ability to allocate securities among multiple incentive plans on a single Form S-8.
  - Permit the addition of securities or classes of securities by an automatically effective post-effective amendment.

- **Implement improvements to simplify share counting and fee payments on the form.**
  - Require the registration of an aggregate dollar amount of securities for defined contribution plans.
  - Implement a new fee payment method for registration of offers and sales pursuant to defined contribution plans in which payment of the fee would be due after the end of each fiscal year.

- **Conform Form S-8 instructions with current Internal Revenue Service (IRS) plan review practices.**
  - The SEC has proposed to eliminate the requirement that issuers undertake to submit any amendment to the plan to the IRS, as well as the requirement to file a copy of the IRS determination letter that the amended plan is qualified under Section 401 of the Internal Revenue Code (since the IRS is only issuing determination letters for amendments to previously qualified plans under very limited circumstances).
  - The proposal would also revise Item 8(b) of Form S-8 to permit an undertaking that issuers will maintain the plan's compliance with ERISA and will make all changes required to maintain such compliance in a timely manner. If the issuer does not provide this undertaking, the requirements of Regulation S-K Item 601(b)(5)(iii) would continue to apply with regard to plan amendments and

therefore require the issuer to file with respect to any amendment a legal opinion confirming compliance of the amended provisions of the plan with the requirements of ERISA.

- **Revise Item 1(f) of Form S-8 to eliminate the requirement to describe the tax effects of plan participation on the issuer.**
  - In a Form S-8, investors are not making a decision whether to approve or disapprove a plan with respect to the issuer; rather, the investment decision is whether to participate in an existing plan.

Both Rule 701 and Form S-8

- **Extend consultant and advisor eligibility to entities subject to the following conditions, which are intended to preserve the connection between the securities being offered or sold to the performance of services:**
  - substantially all of the activities of the entity involve the performance of services; and
  - substantially all of the ownership interests in the entity are held directly by:
    - no more than 25 natural persons, of whom at least 50% perform such services for the issuer through the entity;
    - the estate of a natural person; and
    - any natural person who acquired ownership interests in the entity by reason of the death of a natural person.

- **Expand eligibility for former employees to specified post-termination grants and former employees of acquired entities, which would include:**
  - persons who were employed by or providing services to an issuer during a performance period ending within 12 months preceding resignation or termination of their employment or service for which the securities were issued; and
  - former employees of an acquired entity, as long as the securities are being issued in substitution or exchange for securities that were issued to the former employees of the acquired entity on a compensatory basis while such persons were employed by or providing services to the acquired entity. This provision appears to be intended to address the problem of whether former employees of an acquired entity – who left the acquired entity before the acquisition but who hold outstanding awards that are converted in the acquisition – can be included in the Form S-8 of the acquiring company.
    - In the interest of providing consistent treatment, the SEC has similarly proposed to include offers and sales to former platform workers (described below) ending within 12 months preceding the termination of service for which the securities were issued as well as securities issued to former platform workers of an acquired entity in substitution or exchange for securities that were issued to the former platform workers of the acquired entity on a compensatory basis while such workers were providing bona fide services to the acquired entity.

III. RELEASE NO. 33-10892: TEMPORARY RULES TO INCLUDE CERTAIN PLATFORM WORKERS

As part of this rulemaking initiative, the SEC has been focused on the new types of work relationships between companies and individuals that have become prevalent in the gig economy due in large part to the widespread accessibility of the internet as well as reductions in the costs of communication and information processing. Such arrangements usually involve a worker's use of an internet "platform" provided by a company (the "platform provider") to find a particular type of task or job. The work itself usually entails the individual worker providing services such as ride-sharing, food delivery, household repairs, dog-sitting, or tech support to end-users. These new work relationships are characterized by the individual worker having greater flexibility in determining when and how much he or she works as compared to workers in the traditional employment relationship with an issuer/employer. In addition, these new work relationships are often on a short-term, part-time, or freelance basis. These workers usually provide services or goods through these platforms for multiple companies through which the individual may engage in the same or different business activities. Consequently, the individual workers might not be employees, consultants or advisors eligible to receive securities in compensatory arrangements under either Rule 701 or pursuant to a Form S-8 registration statement.

In Release 33-10892, the SEC has proposed to include on a temporary basis a new category of worker, the "platform worker," within the scope of Rule 701 and Form S-8, while also proposing conditions designed to limit the possibility that the expansion could result in offers and sales for capital-raising purposes. The proposed changes are outlined below. While the SEC is proposing to temporarily expand the eligibility of platform workers for federal securities law purposes, the agency emphasizes that its proposed amendments are not meant and should not be construed to address the legal status of platform workers under other regulatory regimes such as tax or employment law.

Proposed Definition of "Platform Worker"

The proposed rule defines a platform worker as a natural person or an entity[5] who is unaffiliated with the issuer and meets the following conditions:

1. **Provides Bona Fide Services to the Issuer (or its Related Entities)** – The worker must provide bona fide services to the issuer (or the issuer's parent, the issuer's subsidiaries or subsidiaries of the issuer's parent) or to third-party end-users, and such services must benefit the issuer. Selling or transferring permanent ownership of discrete, tangible goods would not constitute services for purposes of this definition.

2. **Services Are Provided Pursuant to a Written Contract or Agreement and through an Internet-based Platform or System** – The services are provided pursuant to a written contract or agreement between the issuer and the worker and are provided through an internet-based platform or other widespread, technology-based marketplace platform or system that the issuer operates and controls, as demonstrated by the following:

    a. the issuer provides access to the platform and establishes the principal terms of service for using the platform;

    b. the issuer establishes the terms and conditions by which the platform worker receives payment for the services provided through the platform (i.e., the issuer establishes the amount of the fees charged for using the platform, which could include any fee charged to the participating worker for the use of the platform as well as any fee or percentage of payment charged to an end-user for the services provided by the worker); and

    c. the issuer can accept and remove the platform worker.

[5] A platform worker may be an entity if substantially all of its activities involve the performance of bona fide services that meet the requirements discussed above and the ownership interest of the entity is wholly and directly held by the natural person performing the services through the entity.

Proposed Conditions for Compensatory Offers and Sales of Securities to Platform Workers

To ensure that any issuances made to platform workers are for compensatory purposes while reducing any opportunity for a platform worker to use his or her relationship with the issuer to engage in speculative activity, the SEC has proposed the following additional requirements:

1. **Issuances Made Pursuant to a Written Compensatory Arrangement *(Applicable to both Rule 701 and Form S-8 issuances)*** – Issuances must be pursuant to a compensatory arrangement that is evidenced by a written compensation plan, contract, or agreement between the issuer and the platform worker. The compensatory arrangement may not be for services 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.

2. **Quantitative Limits on the Value of Compensation the Platform Worker Receives in the Form of Issuer Securities *(Applicable to both Rule 701 and Form S-8 issuances)*** – In order to limit an issuer's incentive and ability to use the new exemptive rule as a conduit for a public distribution of its securities or for other non-compensatory purposes, the proposal includes the following caps on the value of compensation the platform worker can receive in the form of issuer securities:

    a. No more than 15% of the value of compensation received by a platform worker from the issuer for services provided during a consecutive 12-month period.

    b. No more than $75,000 of such compensation received from the issuer during a consecutive 36-month period may consist of securities issued pursuant to Rule 701 or a registration statement on Form S-8.

    The issuer would be required to determine the value of such securities as of the time the securities are granted. For the purpose of assessing compliance with these limits, an issuer would be able to use any reasonable, recognized valuation methodology as long as the methodology is consistently applied during the same 12-month or 36-month period.

3. **Platform Worker Cannot Bargain Individually on the Amount or Terms of the Securities *(Applicable to both Rule 701 and Form S-8 issuances)*** – The proposal requires that the amount and terms of any securities issued to a platform worker may not be subject to individual bargaining. Similarly, as proposed, platform workers would not be permitted to elect between payment in securities or cash.

4. **Issuer Must Take Reasonable Steps to Prohibit the Transferability of Securities Issued to Platform Workers Pursuant to the Rule 701 Exemption Except for Transfers to the Issuer or by Operation of Law *(Applicable just to Rule 701 issuances)*** – Since all securities issued pursuant to Rule 701 are "restricted securities," and any resales must comply with Securities Act registration requirements or qualify for an exemption, the proposal includes an additional transferability prohibition on Rule 701 securities issued to platform workers other than transfers back to the issuer or by operation of law. Transfers by operation of law would include, for example, transfers pursuant to the laws of descent and distribution and domestic relations orders in divorces. According to the SEC, reasonable steps could include the placement of special legends on the securities to be issued to platform workers or appropriate instructions to transfer agents that would provide adequate notice of the transfer prohibition to platform workers.

    The SEC explained in the preamble how this prohibition is intended to prevent the development of a market in such securities until after the issuer becomes subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act, which would in turn greatly reduce, if not eliminate, any incentive for a worker to seek out securities issued pursuant to Rule 701 for speculative purposes.

Temporary, 5-Year Window for Expanded Scope of Eligibility; Requirement to Furnish Certain Information

The SEC's proposed expansion for platform workers would be temporary—the newly proposed Rule 701(h) would apply only to offers and sales of securities occurring within five years following the date of the rule's effectiveness. On that date, Rule 701(h) would expire and no longer be effective. Similarly, the rule authorizing the temporary use of Form S-8 for issuances to platform workers (17 CFR 239.16b(c)) would also expire five years from the date of that rule's effectiveness. According to the SEC, the temporary nature of these amendments is meant to allow the SEC to assess whether unregistered issuances of securities to platform workers under expanded Rule 701, or issuances registered on expanded Form S-8, are being made for appropriate compensatory purposes, and to help the SEC assess whether such issuances have the expected beneficial effects for issuers in the "gig economy," their platform workers, and their investors.

Furthermore, to help in its evaluation of the proposed expanded scope of Rule 701 and Form S-8, the SEC has proposed that any issuer that issues securities to platform workers would be required to furnish information to the SEC at six-month intervals, regarding:

1. the criteria used to determine eligibility for awards, whether those criteria are the same as for other compensatory transactions, and whether those criteria, including any revisions to the criteria, are communicated to platform workers in advance as an incentive;

2. the type and terms of securities issued and whether they are the same as for other compensatory transactions by the issuer during that interval;

3. if issued pursuant to Rule 701, the reasonable steps taken to prohibit the transfer of the securities sold pursuant to this temporary rule;

4. the percentage of overall outstanding securities that the amount issued cumulatively under this temporary rule represents;

5. during the interval, the number of platform workers, the number of non-platform workers, the number of platform workers who received securities pursuant to the temporary rule, and the number of non-platform workers who received securities pursuant to the issuer's Rule 701 or Form S-8 issuances;

6. both in absolute amounts and as a percentage of the issuer's total Rule 701 or Form S-8 issuances during the interval:

    a. the aggregate number of securities issued to platform workers; and

    b. the aggregate dollar amount of securities issued to platform workers.

The required information would be furnished, rather than filed, and would not be subject to potential liability under Section 18 of the Exchange Act. Moreover, the information would be intended only for the SEC's use and would be non-public and would not be furnished through the EDGAR system. Rather, it would be furnished in a non-public manner designated by the Division of Corporation Finance for this purpose, for example, electronically by email or by some other means of electronic communication. Finally, the proposed rules provide that to the extent that the issuer treats such information as privileged or confidential, it may submit a confidential treatment request for the furnished information.

IV. NEXT STEPS

The SEC commissioners voted unanimously to approve the proposals to modernize and harmonize Rule 701 and Form S-8. If finalized as proposed, the amendments should lead to an increase in the use of Rule 701 by non-reporting issuers to the extent that the current disclosure costs discourage non-reporting issuers from relying on it, and should reduce both the complexities associated with registration on Form S-8 and the risk of inadvertent non-compliance by reporting issuers using the form. The status of the companion release temporarily extending the scope of eligibility of Rule 701 and Form S-8 to platform workers is less clear. It was approved by a 3-2 vote over the dissent of the two Democratic commissioners. With the incoming Biden administration, it remains to be seen whether a Democratic-led SEC will support finalizing this rulemaking.

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