Start-up Equity Awards: Securities Law Considerations

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A discussion of key securities law considerations for start-up or early-stage companies preparing to grant compensatory equity awards to employees, directors or other service providers.

Start-up companies often compensate their employees, directors and other service providers in part by granting them equity awards such as restricted stock or stock options. Equity compensation can be particularly useful to start-up companies because these companies often do not have the cash necessary to attract, retain and motivate employees with market-rate salaries. In certain industries, it is standard practice for start-up companies to include equity as a part of every employee's compensation package.

Federal and state securities laws and regulation apply to companies regardless of size and whether or not a company is a Securities and Exchange Commission (SEC) reporting company. Therefore, before a start-up company awards equity compensation to an employee or other service provider, it must ensure that the planned award complies with both federal and state securities regulation. These laws generally require that any offer or sale of securities, including as compensation for services, be registered with the SEC and registered or qualified with applicable state securities regulators unless an exemption applies. A company that makes equity awards without registration or an exemption may:

- Face regulatory action or lawsuits by individuals.
- Jeopardize, delay or harm the economics of a future sale of or investment in the company.

Fortunately, exemptions from both federal and state registration requirements are available for start-up compensatory equity awards in many cases. However, commonly used exemptions often come with conditions and limitations, so counsel to a start-up company must:

- Have a clear idea of which exemption its client is relying on for its awards.
- Ensure that its client understands and complies with all applicable conditions and limitations.

To assist counsel to a start-up company, this Note:

- Examines exemptions from federal registration requirements that start-up companies often rely on when making compensatory equity awards.
- Discusses generally the status of these awards under state securities laws.
- Identifies other key securities law considerations for a start-up company planning to make compensatory equity awards.

This resource focuses solely on securities law considerations relating to start-up compensatory equity awards. For a discussion of the types of equity awards typically granted by start-up companies at different lifecycle stages and related tax and accounting considerations, see *Practice Notes, Choosing the Right Type of Equity Compensation for Start-up Company Employees (http://us.practicallaw.com/3-589-7685)* and *Stock Options and Other Equity Compensation (http://us.practicallaw.com/0-501-9297).*

EQUITY COMPENSATION AND THE SECURITIES LAWS: BRIEF

Equity compensation is a form of compensation representing an ownership interest in the grantor. For a company organized as a corporation, equity compensation generally involves a company issuing to a service provider either stock options or restricted stock. In addition to traditional employees, a company may make compensatory equity awards to other service providers, such as directors, contractors, consultants and advisers. In practice, most companies make equity awards under the terms of a written plan, often referred to as an equity incentive plan.

Under Section 5 of the Securities Act of 1933 (Securities Act), every offer or sale of a security must either:

- Be registered with the SEC.
- Qualify for an exemption from the registration requirement.

For a company that is not already a reporting company, SEC registration of equity awards is almost always prohibitively expensive and impractical. Therefore, when preparing to make equity awards, non-reporting companies such as start-up companies must find an applicable exemption from the SEC registration requirement.

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Each issuance of securities must also comply with all applicable state securities laws (blue sky laws). Blue sky laws generally require a company to register or qualify an offer or sale of securities within a state with that state's securities regulator unless an exemption applies. A federal law, the National Securities Markets Improvement Act of 1996 (NSMIA), preempts the ability of states and their political subdivisions to require state-level registration or qualification of covered securities. The definition of covered securities includes securities sold in transactions exempt from SEC registration under some, **but not all**, of the available exemptions. However, even though covered securities are exempt from blue sky registration and qualification requirements, states are permitted to require notice filings and filing fees for transactions in covered securities within their state. NSMIA also provides that state securities regulators retain the authority to investigate suspected fraud by issuers and unlawful conduct by brokers and dealers in offerings of covered securities.

Generally, the easiest path for a start-up company is to find an exemption from state registration and qualification requirements. Depending on the circumstances, a state law exemption from these requirements may be available, or they may be preempted by NSMIA. However, state notice filing and filing fee requirements often still apply.

EXEMPTION TIMING AND CONCEPT OF SALE

Under the Securities Act, the requirement to register a securities transaction or identify an applicable exemption from registration is triggered each time a security is offered or sold. This means that, for a given equity award, there may be more than one point in time when an exemption from registration must be available.

For example, for an option award, a company may be considered to be making an offer or sale under the Securities Act at multiple times, including when the option:

- Is initially granted to the service provider. The company must find an exemption from registration for the initial grant of the option (for an exception to this, see *Box, No Sale Theory*).
- Is exercised by the service provider. At this point, the company needs an exemption for the issuance of the underlying stock.

CONSEQUENCES OF NOT COMPLYING WITH SECURITIES LAWS

Securities transactions that are not registered with the SEC and that do not qualify for an exemption from registration violate Section 5 of the Securities Act. A company that violates Section 5 can be subject to enforcement action by the SEC and private lawsuits by securities recipients for rescission of the illegal transaction.

This means that a company making compensatory equity awards without registration or a valid exemption from registration may, among other things:

- Find that a planned sale of or equity investment in the company is delayed or jeopardized, or its economics are harmed, when a potential buyer or investor learns of the company's past violation of Section 5.
- Be required to make a rescission offer for securities granted in transactions that violated Section 5.
- Be subject to investigation or enforcement activity by the SEC. Enforcement activity can be focused on the company itself as well as on individuals within the company (such as company attorneys).
- Face claims by recipients of compensatory awards.

A prominent example of a company that experienced adverse consequences as a result of problems with equity awards made when it was privately-held is Google, Inc. For a further discussion of this, see *Practice Note, Employee Incentive Compensation and the Role of Rule 701: Google's Violation of Rule 701 (http://us.practicallaw.com/6-500-5315)*.

A company may also face enforcement action by state securities regulators if it does not comply with applicable blue sky laws.

FEDERAL SECURITIES LAW EXEMPTIONS

Start-up companies primarily rely on one of three exemptions from SEC registration when granting compensatory equity awards. These include:

- Rule 701 under the Securities Act. Rule 701 is by far the most commonly-relied on exemption for start-up equity awards (see *Rule 701 Exemption*).
- Rule 506(b) of Regulation D under the Securities Act. Rule 506(b) is used primarily for awards to directors and executive officers (see *Rule 506(b) Safe Harbor*).
- Section 4(a)(2) of the Securities Act. While it is available under some circumstances, companies rely on the statutory Section 4(a)(2) registration exemption infrequently for equity awards (see *Section 4(a)(2) Statutory Exemption*).

For a chart comparing key pros and cons of each exemption, see *Box, Comparison Chart of Federal Registration Exemptions*.

RULE 701 EXEMPTION

Rule 701 exempts certain compensatory equity awards that are made under a written compensatory benefit plan or compensation contract by a company that is not a reporting company or required to register as an investment company under the Investment Company Act of 1940 (ICA). Rule 701 can only be used for awards made in compensatory circumstances. It cannot be used for capital-raising transactions. Under Rule 701, a compensatory benefit plan is any purchase, savings, option, bonus, stock appreciation, profit sharing, thrift, incentive, deferred compensation, pension or similar plan.

A company can generally rely on Rule 701 for awards to:

- Employees, officers, directors, general partners and trustees.
- Consultants and advisors who are natural persons providing bona fide services to the company (the services must be unrelated to a capital raising or a market in the company's securities).
- Family members of these persons who acquire securities from them through gifts or domestic relations orders.
- Individuals who formerly fell into one of these categories at the time awards were made, despite no longer playing that role. For example, assuming the other conditions of the rule are met, a company can rely on Rule 701 for the issuance of stock underlying an option exercised by a former employee who was granted the option while that employee was still employed by the company.

The requirement that awards be made under a written plan or contract is typically relatively easy for most companies to meet because companies almost always offer equity awards to service providers in writing. A company making an award in reliance on Rule 701 must deliver to each award recipient a copy of the compensatory benefit plan or compensatory contract under which the award is made.

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Rule 701 is a broad exemption specifically designed to help make it feasible for non-reporting companies to grant compensatory equity awards. No SEC filings or approvals are required before or after an award. However, Rule 701 has several restrictions that companies must be aware of, including that:

- There are limits on the aggregate amount of securities a company can award under Rule 701. The first limit is an absolute cap on the aggregate amount of Rule 701 awards in a 12-month period. The second limit is a cap on the aggregate amount of Rule 701 awards a company can make during any 12-month period without providing certain disclosure. A company that exceeds the second limit must provide plan participants with extensive disclosure, which may not be feasible for a start-up company (see *Numerical Limits*).
- A company can rely on Rule 701 to issue equity awards only to natural persons, and not to entities (*Rule 701(c)(i)*).

For a full discussion of the Rule 701 exemption, see *Practice Note, Employee Incentive Compensation and the Role of Rule 701 (http://us.practicallaw.com/6-500-5315).*

Numerical Limits

Rule 701 includes two numerical limits, both of which apply only to actual issuances, not to offers.

The first limit is an absolute cap on the amount of securities a company may issue in reliance on Rule 701 in any 12-month period. Under this limit, the aggregate sales price or amount of securities a company issues in reliance on Rule 701 during any consecutive 12-month period may not exceed the greatest of:

- $1 million.
- 15% of the company's total assets measured at the company's most recent balance sheet date (if no older than its last fiscal year end).
- 15% of the outstanding amount of the class of securities being offered and sold, measured at the company's most recent balance sheet date (if no older than its last fiscal year end).

For many start-up companies, $1 million is the greatest of these amounts.

Under the second limit, if the aggregate sales price of the securities granted under Rule 701 during any 12-month period exceeds $5 million, in addition to providing each award recipient with a copy of the compensatory benefit plan or contract, the company must provide additional disclosure to these individuals, including company financial statements. For a full description of the required disclosure, see *Practice Note, Employee Incentive Compensation and the Role of Rule 701: Disclosure Obligations (http://us.practicallaw.com/6-500-5315 #a931256).*

Many companies may be unable or unwilling to make the disclosure required if the second limit is exceeded. These companies must ensure that they do not exceed the $5 million limitation (although in practice, the $1 million absolute cap will apply to many start-up companies, making the $5 million limit irrelevant). For more information on how securities are valued for purposes of these limits, see *Box, Valuation Rules*.

Companies relying on Rule 701 should have a system in place to:

- Determine the value of each award the company makes in reliance on Rule 701.
- Track, record and keep a running total of their Rule 701 awards on an ongoing basis.

A company that is concerned that it may exceed either limit may consider relying on the Rule 506(b) safe harbor for awards to service providers that are accredited investors (AIs), such as the company's directors, executive officers and other individuals that meet the definition of AI (see *Integration* and *Rule 506(b) Safe Harbor*).

Integration

The doctrine of integration is a concept under the securities laws used to determine whether, among other things, two or more purportedly discrete exempt offerings are really one offering that does not qualify as an exempt offering.

Rule 701 specifies that Rule 701 transactions are not integrated with other offerings (*Rule 701(f)*). This means that a company can make awards under Rule 701 at the same time it is:

- Raising capital by selling securities in transactions relying on other registration exemptions.
- Making compensatory equity awards to AIs in reliance on the Rule 506(b) safe harbor (see *Rule 506(b) Safe Harbor*).

The amount of compensatory awards made under another registration exemption (such as Rule 506(b)) do not count towards Rule 701's numerical limits (*Rule 701(d)(3)(iv)*).

For a general discussion of integration, see *Practice Note, Multiple Offerings: Dealing With Integration (http://us.practicallaw.com/1-381-9554).*

Common Rule 701 Mistake: Failure to Deliver All Required Plan Documents

One notable requirement of Rule 701 is that the company must deliver to award recipients a copy of the compensatory benefit plan or compensation contract under which their awards are made. While this is not a difficult burden, companies sometimes inadvertently fail to provide all applicable documents to award recipients.

For example, a company must provide optionees with both a copy of their individual stock option agreement and the stock option or equity incentive plan under which the option was granted. Therefore, if a company's plan provides for a notice of grant of stock option, a stock option agreement and a stock option plan, the company must provide all three documents to each optionee. However, sometimes companies will only provide optionees with a notice of grant and the stock option agreement. This is not sufficient.

A company should set up a process to ensure that each person receiving an award made in reliance on Rule 701 receives all applicable plan documents. Counsel should carefully review the company's plan and identify this set of documents.

Rule 701 Awards and Blue Sky Laws

Securities issued in Rule 701 transactions **are not** covered securities under NSMIA (see *Preliminary Note 2, Rule 701 and Section 18(a)(4), Securities Act*). They therefore do not benefit from NSMIA's preemption of state registration and qualification requirements. This means that a company making equity awards under Rule 701 must examine the securities laws and regulations of the state in which the

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recipient of an equity award resides to identify a state law exemption from state registration or qualification requirements.

State securities laws differ, and counsel must always review current state law when advising its client. However, generally speaking:

- Some states' blue sky laws include an exemption from registration or qualification requirements that is analogous to Rule 701. However, unlike Rule 701, these exemptions may require that, before a company makes awards to state-resident service providers, the company must:
  - clear a transaction with the state regulator; or
  - make certain filings with the state regulator.
- Some states' securities laws include an exemption from registration requirements for transactions involving compensation plans that meet certain Internal Revenue Code (Code) requirements.

For instance, Section 25102(o) of the California Corporations Code is the most commonly used exemption from state registration requirements used by companies making equity awards to California residents. California's Section 25102(o) exemption is available for offers or sales of securities made under a purchase or option plan or agreement that are exempt from SEC registration under Rule 701 if:

- The plan or agreement meets certain conditions, which generally include that it, among other things:
  - limits the total number of securities issuable and eligible participants;
  - places restrictions on the transferability of the issued securities and exercise period of options;
  - has been approved or will be approved by a required percentage of the issuer's stockholders; and
  - provides for certain security holders to receive annual disclosure, including company financial statements.
- The issuer makes a notice filing with the California Securities Regulation Division and pays a filing fee within 30 days of the initial issuance under the plan.

Counsel to a company planning to rely on California's Section 25102(o) exemption must carefully analyze the company's compensation plan (and any proposed amendments) to ensure that it meets the applicable requirements of the rule.

Counsel should recognize that California has a relatively complex legal framework for compensatory equity awards, with other provisions that may apply to a given award. For example, Section 25102(f) of the California Corporations Code may also be a useful alternative exemption in some circumstances.

By contrast, the state of Washington provides an exemption from state registration and qualification requirements and from state notice filing and fee requirements for issuances under an employee stock purchase or similar benefit plan if either:

- The plan meets the definition of one of several types of plans under the Code.
- The Washington Department of Financial Institutions is notified in writing and provided with a copy of the plan 30 days before the securities are offered in Washington under the plan.

(*Wash. Rev. Code Ann. § 21.20.310(10)*.)

If a state does not have an exemption specifically tailored for equity awards under Rule 701, an award exempt from federal registration under Rule 701 may qualify for a state's exemption designed for another type of exempt offering, such as Rule 506.

It is critical for counsel to note that even if an award is exempt from state registration and qualification under a state law exemption, state law may still require state-level notice filings (as in California). To avoid missing deadlines, companies and their counsel should understand all applicable state-level requirements **before** granting an equity award.

Valuation Rules

For purposes of calculating Rule 701's numerical limits, aggregate sales price means the sum of all cash, property, notes, cancellation of debt or other consideration received or to be received by the company for the sale of securities, calculated on the grant date (a different rule applies to deferred compensation plans).

To place a value on services an individual provides in exchange for securities, a company must look to the value of the securities issued (not to the employee's salary or consultant's invoice).

When valuing options, a company must:

- Value options based on their exercise price. For example, an option to purchase one share at a $1 per share exercise price counts for $1 toward the limitation. In this example, a company with a $1 million absolute cap cannot grant these options on more than 1 million shares during any 12-month period.
- Make the value determination on the date an option grant is made (without regard to when the option becomes exercisable). For example, if a start-up company issues $500,000 of options, subject to vesting over four years, it must count the entire $500,000 on the grant date, regardless of the vesting schedule.

The amount of compensatory awards made under another registration exemption (such as Rule 506(b)) does not count towards Rule 701's numerical limits (*Rule 701(d)(3)(iv)*).

Pre-grant Questions

Counsel to a company planning to make a compensatory equity award in reliance on Rule 701 must determine whether:

- The company has capacity under Rule 701's absolute cap.
- The company has triggered or will trigger Rule 701's disclosure requirement. If so, counsel must determine whether the company realistically can prepare the required disclosure. For administrative or competitive reasons, the answer may be no.
- Each grantee is a permissible recipient of an award under Rule 701.
- The company has identified all of the documents it must provide to award recipients.
- The company has identified the state in which each award recipient resides.
- The company has identified an available state securities law exemption and prepared to comply with its conditions, including substantive requirements (if any) and the filing of forms and payment of fees.

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RULE 506(b) SAFE HARBOR

Rule 506(b) is one of the most common registration exemptions that start-up companies rely on for capital-raising transactions. A company also may rely on this popular exemption for certain compensatory equity awards.

There is no limit to the aggregate amount of securities a company can issue in reliance on Rule 506(b). Companies commonly rely on Rule 506(b) for awards to directors or executive officers when an award would cause the company to exceed Rule 701's numerical limits (see *Numerical Limits*). Offers and sales made under Rule 506(b) can be integrated with other offerings, including other Rule 506(b) offerings. However, they are not integrated with Rule 701 transactions (see *Integration*).

In practice, Rule 506(b) is only available when an award recipient is an AI. This is because Rule 506(b) requires comprehensive disclosure in an offering involving non-AIs, and it is usually impractical for a start-up company to prepare this type of disclosure. By contrast, there are no specific disclosure obligations in a Rule 506(b) offering made exclusively to AIs. A company's directors and executive officers are AIs for purposes of the company's securities issuances, regardless of those individuals' income or net worth (*Rule 501(a)(4), Securities Act*). Other service providers may also be AIs as a result of their income or net worth.

One notable requirement of Rule 506(b) is that the company must file a Form D with the SEC. For more information on filing Form D, see *Practice Note, Form D: Notice of Exempt Offering of Securities (http://us.practicallaw.com/3-573-7885).*

A company making an award in reliance on Rule 506(b) is also usually required to make a notice filing with, and pay filing fees to, regulators in each state where an award recipient resides (see *Rule 506(b) Awards and Blue Sky Laws*).

Under Regulation D's bad actor disqualification provision, subject to certain exceptions, a company cannot rely on Rule 506(b) for its securities offering if the company or certain related persons have certain disqualifying events in their past. For a detailed discussion of the bad actor disqualification provision and the other requirements of Rule 506(b), see *Practice Note, Section 4(a)(2) and Regulation D Private Placements (http://us.practicallaw.com/8-382-6259).*

Rule 506(b) Awards and Blue Sky Laws

Securities offered under Rule 506(b) are covered securities under NSMIA. Therefore, state securities law registration and qualification requirements that might otherwise apply to an award are preempted (*Sections 18(a)(1)(A) and 18(b)(4)(E), Securities Act*).

However, NSMIA permits a state securities regulator to require an issuer of covered securities in its state to make a state-level notice filing and pay a filing fee, subject to certain exceptions. Almost all states require notice filings and filing fees for Rule 506(b) transactions within their state. For information on complying with these requirements, see *Standard Document, Blue Sky Filing Cover Letter, Regulation D Rule 506 Offering (http://us.practicallaw.com/5-526-6228).*

NSMIA also provides that state securities regulators retain the authority to investigate suspected fraud by issuers and unlawful conduct by brokers and dealers in offerings of covered securities.

SECTION 4(a)(2) STATUTORY EXEMPTION

Section 4(a)(2) is a statutory exemption from registration for offers and sales of securities by an issuer that do not involve a public offering. While public offering is not defined under the Securities Act, its definition has been elaborated on by courts and in SEC rulings and guidance. This body of law and guidance identifies several factors that, when present, support the claim that an offering is a private offering, including that:

- The offering involves a limited number of investors.
- Only financially sophisticated investors participate.
- Prospective investors have access to detailed information about the company.

Despite this, this guidance does not provide bright-line rules on the parameters of a private offering.

Because a company has the burden of demonstrating that it qualifies for an exemption, companies are often reluctant to rely on Section 4(a)(2). In fact, uncertainty about the exact parameters of what constitutes a private offering was the reason why the SEC created private offering safe harbors such as Rule 506(b). Rule 506(b) is a safe harbor under Section 4(a)(2) because it provides detailed requirements which, if followed, allow the company to demonstrate that its offering is exempt under Section 4(a)(2).

For this reason, companies rarely rely on Section 4(a)(2) (without also relying on a safe harbor such as Rule 506(b)) when making compensatory equity awards. Rule 4(a)(2) may be a useful alternative in certain circumstances, such as a larger compensatory award to a company founder.

For a detailed discussion of the Section 4(a)(2) exemption, see *Practice Note, Section 4(a)(2) and Regulation D Private Placements (http://us.practicallaw.com/8-382-6259).*

Section 4(a)(2) and Blue Sky Laws

Securities sold in a transaction exempt under Section 4(a)(2) (that does not also rely on Rule 506) are not covered securities under NSMIA. Therefore, they do not benefit from NSMIA's preemption of state registration and qualification requirements. This means that the company must examine the securities laws and regulations of each state in which a recipient of equity compensation resides to identify a state law exemption from state registration and qualification requirements.

RESALES OF COMPENSATORY SHARES

A key consideration for recipients of equity compensation is how and when they may resell their company securities. This question typically turns on two separate considerations:

- **Contractual restrictions on resale.** The terms of a compensatory award usually include contractual restrictions on the ability of the grantee to transfer the securities. For example, compensatory awards such as restricted stock are subject to certain restrictions for a period of time, often including that the stock is non-transferable and subject to forfeiture or repurchase by the company under certain circumstances. For a further discussion of these types of restrictions, see *Practice Notes, Choosing the Right Type of Equity Compensation for Start-up Company Employees (http://us.practicallaw.com/3-589-7685)* and *Stock Options and Other Equity Compensation (http://us.practicallaw.com/0-501-9297).*

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- **Securities law restrictions on resale.** Securities received from a company in a compensatory award exempt under any of the three registration exemptions discussed above are restricted securities under the Securities Act (see *Rule 701(g)(1), Securities Act and Rule 144(a)(3), Securities Act*). The Securities Act strictly limits the circumstances under which restricted securities can be resold, regardless of the terms of the securities or the contractual arrangements between the company and the securityholder.

In analyzing when and whether stock acquired in a compensatory award can be resold, counsel must understand the difference between, and not confuse or conflate, the meanings of the terms restricted stock and restricted securities.

While a company remains a non-reporting company, restricted securities (within the meaning of the Securities Act) typically may be sold only:

- Under Rule 144 under the Securities Act. Rule 144 resales of restricted securities are subject to certain conditions, including a minimum holding period and, in some circumstances, the availability of current public information about the issuer. Rule 144 imposes stricter conditions on resales of securities by company affiliates. As a practical matter, a non-reporting company is often unable or unwilling to provide information satisfying the current public information requirement applicable to affiliate resales under Rule 144. This makes it impossible for an affiliate of that company to sell securities under Rule 144 while the company remains private. For more information on Rule 144 resales, see *Practice Note, Resales Under Rule 144 (http://us.practicallaw.com/4-382-8769).*
- In private resale transactions exempt from registration under the principal known as Section 4(1½) or the resale safe harbor provided by Rule 144A under the Securities Act. For information on these types of private resales, see *Practice Note, Resales Under Rule 144A and Section "4(1½)" (http://us.practicallaw.com/6-382-8768).*

Also, separate from contractual and legal restrictions on resale, compensatory shares cannot be sold unless there is an interested buyer. There often is no market for resales of shares of non-reporting companies.

After a company goes public, Securities Act restrictions on resales of its restricted securities continue to apply. However, as a legal matter, there often are additional resale opportunities not available while the company remained private. For a further discussion of this, see *Practice Notes, Resales Under Rule 144 (http://us.practicallaw.com/4-382-8769)* and *Employee Incentive Compensation and the Role of Rule 701: Resale Issues (http://us.practicallaw.com/6-500-5315).*

Blue sky laws may also place restrictions on resales of securities issued in a compensatory award. These blue sky resale restrictions generally fall away when a company goes public. This is because NSMIA preempts the ability of states to require state registration and qualification or notice filings or fees regarding resale transactions in securities listed on certain stock exchanges (see *Section 18(b)(1) and 18(c)(2)(D), Securities Act*).

For a further discussion of secondary trading in non-reporting company securities, see *Practice Note, Secondary Market Trading of Private Company Shares (http://us.practicallaw.com/3-505-1276).*

EXCHANGE ACT CONSIDERATIONS

Section 12(g) of the Securities Exchange Act of 1934 (Exchange Act) requires a company to register a class of equity securities under the Exchange Act (and become a reporting company) if both:

- Its total assets exceed $10 million.
- There are either 2,000 or more "record holders" of that class of equity securities or 500 or more record holders of the class that are not AIs (a different threshold applies to bank holding companies).

For more information on Section 12(g), see *Practice Note, Exchange Act Registration: Overview (http://us.practicallaw.com/7-506-3135).*

The Jumpstart Our Business Startups Act (JOBS Act) introduced reforms allowing a company to exclude persons holding company stock issued to them in compensatory awards from the calculation of record holders. These reforms seek to prevent a non-reporting company from being effectively precluded from granting equity compensation to avoid triggering the threshold that would require it to register as a public company.

Under Section 12(g)(5) of the Exchange Act (as amended by the JOBS Act), securities held by persons who received the securities under an employee compensation plan in a transaction exempt from registration are not considered to be held of record for purposes of the Section 12(g) record holder calculation. SEC guidance has clarified that a company can continue excluding from its record holder count a person holding shares that the person received under a compensation plan even when that person no longer works for the company. However, the exclusion no longer applies once securities are transferred to another holder (see *Question 5, JOBS Act Frequently Asked Questions, Changes to the Requirements for Exchange Act Registration and Deregistration*). For more information on this guidance and on proposed rulemaking under Section 12(g)(5), see *Practice Note, JOBS Act: Exchange Act Registration Thresholds Summary (http://us.practicallaw.com/8-518-7084).*

Rule 12h-1(f) under the Exchange Act, which predates the JOBS Act, also exempts certain stock options issued by non-reporting companies under written compensatory stock plans from the Section 12(g) registration requirement.

INVESTMENT COMPANY ACT CONSIDERATIONS

The SEC adopted the Rule 701 exemption under its Securities Act Section 3(b) and Section 28 authority. These statutory provisions respectively give the SEC the authority to adopt registration exemptions for certain small offerings and when an exemption is necessary or appropriate in the public interest (see *SEC Release No. 33-7645*). Unlike Rule 506(b), Rule 701 **is not** a private offering safe harbor under Section 4(a)(2) of the Securities Act. Therefore, transactions that comply with Rule 701 may be (and typically are) exempt **public offerings** under the Securities Act.

This may be relevant to a company that, because of its structure, must rely on an exception from the definition of investment company under the ICA. Two commonly used exceptions, ICA Sections 3(c)(1) and 3(c)(7), are only available to issuers that, among other things, do not publicly offer their securities. Companies relying on these exceptions also have to comply with other requirements which may be harder to meet if the company makes Rule 701 awards.

A company that may need to rely on these exceptions from the definition of investment company should consider this before making compensatory awards under Rule 701 that do not also qualify for a private offering exemption, such as Rule 506(b) or Section 4(a)(2).

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COMPARISON CHART OF FEDERAL REGISTRATION EXEMPTIONS

The following chart identifies some of the key pros and cons of the listed exemptions from Securities Act registration in the context of start-up equity awards.

Exemption	Advantages	Disadvantages
Rule 701 under the Securities Act	Most commonly used exemption for start-up equity awards, meaning counsel, companies and service providers are most likely to be familiar with it. Exemption specifically designed for compensatory equity awards, providing considerable certainty to a company relying on it. No SEC filing requirement. Anti-integration provision allows the company to conduct capital-raising transactions and compensatory awards under other registration exemptions, simultaneous to Rule 701 awards without concern about integration of transactions.	Annual limit applies on securities issued under the exemption. Disclosure requirements apply if more than $5 million of securities are granted within any 12-month period. Securities are not covered securities under NSMIA, meaning the company must find and comply with state law exemptions from state registration and qualification requirements. Awards may only be made to natural persons.
Rule 506(b), Regulation D	No limit on the aggregate amount of awards made in reliance on the safe harbor. Securities are covered securities under NSMIA, meaning state registration and qualification requirements are preempted (although notice filings and filing fees are typically required). No particular disclosure requirements (if grantees are limited to AIs).	Not practical when awards are made to non-AIs. Form D filing required. Bad actor disqualification provision applies.
Section 4(a)(2)	No limit on the aggregate amount of awards made in reliance on the exemption. In contrast to Rule 506(b) safe harbor, bad actor disqualification provision and Form D filing requirement do not apply.	Lack of certainty for the company regarding its ability to show that awards qualify for the exemption. Securities are not covered securities under NSMIA, meaning the company must find and comply with state law exemptions from state registration and qualification requirements.

NO SALE THEORY

Under case law and SEC guidance, an employer's award of stock options to employees is not considered an offer or sale of securities if:

- The awards are made under an established plan.
- The options are not specifically bargained for by the employees.
- The options are granted for no consideration other than the employees' previously agreed services.

These circumstances and, in particular, the absence of individual bargaining, are generally less likely to apply in the context of a newly-formed company than in the context of a large and established business. For further guidance on this concept, sometimes referred to as the "no sale" theory, see *SEC Release No. 33-6188* at page 15 and footnote 84 and accompanying text, *Yoder v. Orthomolecular Nutrition Inst., Inc., 751 F.2d 555, 561 (2d Cir. 1985)* and *Dubin v. E.F. Hutton Grp. Inc., 695 F. Supp. 138, 146 (S.D.N.Y. 1988)*.

However, even if an initial grant of options is not considered a sale, the company still needs to find an exemption applicable to the sale that occurs when and if the options are exercised (see *Exemption Timing and Concept of Sale*).

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