Securities and Corporate Law Developments

EXECUTIVE COMPENSATION DEVELOPMENTS

SEC AMENDMENTS ADDRESS EMPLOYEE BENEFIT PLANS

The Securities and Exchange Commission (the "SEC") has adopted amendments, which became effective on April 7, 1999, to Rule 701 under the Securities Act of 1933 (the "Securities Act") and to Form S-8.[1/] Rule 701 exempts from registration the securities private companies issue under employee benefit plans. Form S-8 provides a simplified form for public companies to register securities they issue under employee benefit plans. The adopted amendments update and simplify the rules relating to employee benefit plans for both private and public companies and expand the flexibility and availability of their provisions in light of current practices and circumstances.[2/]

A. Rule 701 Amendments

Rule 701 allows private companies to sell securities to their employees and certain other service providers without the need to file a registration statement with the SEC. The exemption from registration covers securities offered or sold under a written plan or agreement between a non-reporting (private) company (whether foreign or domestic), or its parents or majority-owned

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[1/] Rule 701 — Exempt Offerings Pursuant to Compensatory Arrangements, Securities Act Release No. 33-7645 (Feb. 25, 1999), 64 Fed. Reg. 11,095 (Mar. 8, 1999); Registration of Securities on Form S-8, Securities Act Release No. 33-7646 (Feb. 25, 1999), 64 Fed. Reg. 11,103 (Mar. 8, 1999).

[2/] In addition to the amendments discussed in this newsletter, the SEC adopted other amendments to Form S-8 and proposed additional amendments to Form S-8 in connection with its crackdown on microcap fraud. The other adopted and proposed amendments are intended to prevent issuers from using nominal "consultants and advisors" as conduits to evade the registration requirements of Section 5 of the Securities Act and to prevent the registration of securities issued to consultants and advisors for stock promotion services. These amendments are discussed in a separate, companion newsletter dated May 24, 1999.

subsidiaries, and the company's employees, officers, directors, partners, trustees, consultants and advisors. The purpose of the exemption is to minimize the expense and disclosure obligations of private companies, many of which are small businesses, when their only securities sales are to employees, and where these sales are for compensatory and incentive purposes, rather than for capital-raising. A person who receives stock under Rule 701 will have "restricted stock," subject to resale restrictions, although those restrictions are substantially relaxed 90 days after the issuer becomes a public company.

The amendments to Rule 701 adopted by the SEC:

- increase the amount of securities that can be offered and sold in reliance on the exemption;
- require disclosure (including risk factors and financial statements) in offers relying on the exemption;
- limit the extent to which the issuers can use the exemption to issue securities to consultants and advisors; and
- explicitly refer to deferred compensation arrangements as covered by and subject to the rule.

1. Increase in Exemptive Limit

Rule 701 previously limited the total amount of securities that could be offered in any 12-month period to the greater of $500,000 or an amount determined under one of two formulas. One formula limited the amount to 15% of the issuer's total assets, and the other to 15% of the outstanding securities of the class being offered. In any event, Rule 701 restricted the aggregate offering price of securities subject to outstanding offers (i.e., including options) and the amount sold in any 12-month period to no more than $5 million.

Many small businesses and even larger private companies have taken advantage of Rule 701 to exempt offers and sales of up to $5 million per year. However, in light of inflation, the increased popularity of equity ownership as a retention and incentive device for employees, and the growth of deferred compensation plans, the SEC determined that the $5 million limit had become unnecessarily restrictive. Accordingly, the SEC used its new Securities Act exemptive authority[3/] to amend Rule 701 to set the maximum amount of securities that may be sold in any

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[3/] *See* Pub. L. 104-290, 110 Stat. 3416 (1996) (enacting the National Securities Markets Improvement Act of 1996, which gave the SEC authority to provide exemptive relief from Securities Act registration without a dollar limit).

12-month period at the *greatest* of: (i) $1 million (rather than the previous $500,000 limit); (ii) 15% of the issuer's total assets; or (iii) 15% of the outstanding securities of that class. The amendment eliminates the $5 million aggregate offering price ceiling.[4/] The dollar limits of the amended Rule 701 apply only to actual sales of securities, and do not apply to offers. Shares to be received on exercise of options are counted against the dollar limit at their exercise price at grant date, rather than on exercise.

2. Enhanced Disclosure to Purchasers

All issuers must deliver to anyone who receives compensatory options or other securities a copy of the applicable compensatory benefit plan or contract. If an issuer sells more than $5 million worth of securities during a twelve-month period, that issuer is now also required to:

- disclose to each purchaser information about the risks associated with the investment;
- deliver a copy of the summary plan description required by the Employee Retirement Income Security Act of 1974 ("ERISA"), or if the plan is not subject to ERISA, a summary of the plan's material terms; and
- provide the financial statements required in an offering statement on Form 1-A under Regulation A[5/].

The disclosure requirements set forth above apply to all issuers, including foreign private issuers.

Issuers who may exceed the $5 million ceiling within 12 months should consider providing such disclosures at the beginning of the period, because the preamble to amended Rule 701 states that the loss of exemption from registration would be retroactive. Issuers are to provide the disclosures a reasonable period of time before an option is exercised or, for deferred compensation plans, before the participant makes an irrevocable election to defer compensation.

[4/] The SEC retained the requirement that issuers provide whatever disclosures are adequate to satisfy the antifraud provisions of the federal securities laws and also stated that Rule 701 does not preempt the requirement to comply with state "blue sky" laws.

[5/] Part F/S of Form 1-A generally requires the following financial statements: (1) balance sheet; (2) statements of income, cash flows and stockholders' equity; (3) financial statements of businesses acquired or to be acquired; and (4) pro forma financial information. Although Form 1-A allows for unaudited financial statements, issuers that have audited financial statements must provide them.

3. Limiting the Scope of Eligible Consultants and Advisors

Consultants and advisors, like regular employees, may receive securities under the Rule 701 exemption or, where the issuer is a reporting company, in a transaction registered on Form S-8. Although the definitions of the term "consultants and advisors" in Rule 701 and Form S-8 are identical, the SEC staff has historically interpreted Rule 701 to permit participation by a broader range of consultants and advisors than would be permitted on Form S-8.

Rule 701 now includes a new definition of "consultants and advisors" that matches the new definition in Form S-8 and narrows the scope of eligible consultants and advisors. The new Rule 701 definition, which the SEC intends to interpret consistently with the new Form S-8 definition, clearly excludes promoters of securities from the scope of eligible persons. The amendment also excludes independent agents, franchisees, and salespersons who do not have an employment relationship with the issuer from the scope of "consultant or advisor." However, other persons who display significant characteristics of "employment" may qualify as eligible to participate under the exemption, depending on the particular facts and circumstances. The revised Rule also specifies that "consultants and advisors" for this purpose are individuals, not companies, that provide bona fide services not related to capital raising or maintaining a market for securities.

4. Deferred Compensation

Rule 701 now explicitly refers to deferred compensation arrangements.[6/] For the past few years, the SEC has taken the informal position that deferred compensation arrangements may be securities (generally debt obligations) that must be registered or exempted. New Rule 701 makes clear that it is available to exempt deferred compensation that fits its terms. The issuer will count the deferred compensation against the $5 million disclosure floor using the amount of compensation at the time of an irrevocable deferral (rather than the deferred compensation balance at some later point).

5. Clarifying and Simplifying Amendments

In addition to the principal changes discussed above, the amendments to Rule 701 also include the following clarifying and simplifying changes:

- Sales to employees of majority-owned subsidiaries of the issuer's parent (i.e., brother-sister subsidiaries) are now exempt from registration under Rule 701.

[6/] The SEC did not carry this explicit reference over to the amendments relating to Form S-8, although we are not aware of any reason its position would be different for public companies.

- Option exercises by family members of employees who acquire Rule 701 securities from the employee through a gift or domestic relations order (for example, under a divorce or support decree) are now exempt from registration.[7/]

- A private, wholly-owned subsidiary can use its parent's assets, whether or not the parent is a public company, in making the 15% of assets calculation. The parent must fully and unconditionally guarantee the applicable obligations of the subsidiary and the amount guaranteed must not exceed 15% of the parent's assets. The rule also exempts the parent's guaranty from registration.[8/]

- Sales to former employees may be completed under the rule if those persons were employees when the securities were initially offered.

B. Form S-8 and Related Amendments

Form S-8 is the short form registration statement for offers and sales of securities to employees, outside directors, and certain other service providers. Form S-8 allows an issuer to use employee benefit plan documents provided by the employer (which could include a simplified prospectus) and periodic reports incorporated by reference to satisfy the disclosure obligations. Form S-8s are effective automatically upon filing and are not subject to SEC staff review. The SEC has allowed such abbreviated disclosure and processing because of the compensatory nature of these offerings and because of the recipients' presumed familiarity with the company's business. The amendments to Form S-8 and related rules:

- facilitate the exercise of stock options transferred to employees' family members; and

- require additional executive compensation disclosures.

1. Facilitating Intra-Family Transfers of Stock Options

[7/] Both amended Form S-8 and Rule 701 now use the same definition of "family member" for these purposes — any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, former spouse, sibling, niece, nephew, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, sister-in-law, including adoptive relationships, any person sharing the employee's household (other than a tenant or employee), a trust in which these persons (or the employee) control the management of assets, and any other entity in which these persons (or the employee) own more than fifty percent of the voting interests.

[8/] This amendment is intended to assist small companies that are subsidiaries of larger public or private companies in offering deferred compensation arrangements at the subsidiary level.

In the stock option area, Form S-8 previously was available only to register stock received on option exercises by current and former employees or other service providers. If an issuer wanted to allow an employee's family members to exercise stock options that were transferred to them, the issuer was required to register the sale of the stock upon exercise of the options using Form S-3 (which is a less streamlined registration statement and is subject to staff review).[9/]

The incentive for an employee, during his lifetime, to transfer his options to his family members, who could then exercise them, lies in the potentially significant tax savings available under current law.[10/] It may be far more costly for the employee to exercise his options during his lifetime, and then pass on these securities to his family members through his taxable estate. Accordingly, to facilitate intra-family transfers of options by employees for estate planning purposes and under domestic relations orders, Form S-8 will now cover stock option exercises by employees' family members who have acquired the options from the employee as a gift or through a domestic relations order.

We note, however, that transferable options may provide fewer estate, gift, and income tax advantages than seemed likely when the SEC began considering these changes. The Internal Revenue Service ("IRS") had already stated its position that the original optionee is subject to income tax when a transferee exercises an option. Some practitioners had assumed that the IRS would treat an option transfer as a completed gift for tax purposes but with little value if transferred when the exercise price was at or above the market value or when the option was not exercisable. The IRS, however, concluded last year that options do have value and that transferred options are only completed gifts for tax purposes when and to the extent the options are exercisable. The effect of these conclusions was to greatly decrease the usefulness of transferable options for tax planning.

2. Executive Compensation Disclosure

Item 402 of Regulations S-K and S-B requires disclosure of options granted to, held by, or exercised by certain officers of an issuer. The SEC adopted amendments to Regulation S-K and S-B that specify that issuers must disclose as compensation for an officer the options and

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[9/] In the same release that amended Form S-8, the SEC amended Form S-3 to explicitly make it available for the offer and sale of securities underlying both warrants and options, regardless of whether the securities are transferable or not.

[10/] Incentive stock options ("ISOs") are generally nontransferable by their terms, although the IRS has allowed some very limited transfers without disqualifying the ISO's tax-favored status. Nonqualified stock options do not have the same prohibition on transfers.

stock appreciation rights (SARs) that were granted during the year and have been transferred.[11/]

The SEC did not adopt an earlier proposal to require extensive disclosure about consultants and advisors, although it did seek additional comments about what disclosures would be appropriate to ensure that such persons are actually providing bona fide services not related to capital raising. Under the earlier proposals, issuers would have been required to disclose the consultants and advisors' names, specific services provided, and number of securities received. Some form of that disclosure may yet be adopted.

Impact of the Amendments

The amendments to Rule 701 and Form S-8 reflect a recognition that stock options have become an increasingly important component of employee compensation and respond by simplifying the rules governing employee benefit plans. Private companies that rely on Rule 701 to compensate their employees should benefit from the increase in the exemptive limit, as well as the other clarifying and simplifying amendments discussed above. In addition, some optionees may benefit from the new rules on transferable options.

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Please contact Meredith Cross (202) 663-6644, R. Scott Kilgore (202) 663-6116, Roger Patterson (202) 663-6246, or Kevin Carroll (410) 986-2890 if you have questions.

[11/] *See* Items 402(b) and (c), respectively, of Regulations S-K and S-B. The SEC is currently reviewing the aggregate option/SAR exercises and fiscal year-end option/SAR value table for possible amendment in the future and has expressed the view that issuers should report options exercised and held by transferees as though they were exercised or held by the executive officer.

WILMER, CUTLER & PICKERING

2445 M Street, N.W.
Washington, D.C. 20037-1420
Telephone: (202) 663-6000
Facsimile: (202) 663-6363
www.wilmer.com

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