CHAPTER **8**

Securities Law Considerations

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Closely held companies that compensate employees with equity, either directly or through qualified or nonqualified benefit plans, must be mindful of the complex federal and state securities law considerations that arise as a result. The federal securities laws are primarily the Securities Act of 1933 (the Securities Act) and the Securities Exchange Act of 1934 (the Exchange Act). State securities laws, known as "blue-sky laws," apply to intrastate issuances of securities, not to the more common interstate dealings that trigger application of federal securities laws.

The securities laws are complex, highly technical rules, which, when violated, result in severe penalties. The following discussion merely highlights several of the most significant of these rules. Any securities-related action—including issuing equity compensation to employees—requires a thorough examination and understanding of the securities laws involved.

We begin with a brief review of the registration requirements under the Securities Act, their application to benefit plans, and the most commonly used registration exemptions. What follows is a brief discussion of the Exchange Act's registration and reporting requirements, the anti-fraud rules, and the role played by state securities laws. Finally, because a significant number of closely held companies each year consider public offerings of their shares, we take a brief look at "cheap stock" as a securities-law-related issue that applies to private companies that go public.

Reporting and Disclosure Requirements Under the Federal Securities Laws

The Securities Act and the Exchange Act regulate the offer, purchase, and sale of securities. In several instances, the acts impose reporting and disclosure requirements on employee benefit plans and other related parties.

The Securities Act

The Registration Requirement

The Securities Act provides that securities may not be offered or sold unless a registration statement is filed with the Securities and Exchange Commission (SEC) or an exemption from registration applies. For purposes of the Securities Act, a "sale" of a security is defined as a disposition of the security for "value," i.e., property, cash, or services. To determine whether a plan interest or asset that is being offered or sold by the plan must be registered, the issuer must consider:

- Whether the interest or asset is a security;
- If so, whether the transaction constitutes an offer or sale;
- If so, whether an applicable exemption from registration is available.

Either the participants' individual interests in the employee benefit plan (participation interests) or the assets held by the plan, such as employer stock, may constitute "securities" subject to registration. Thus, for example, an equity compensation vehicle can be issued only if the stock is registered or pursuant to an exemption from registration.

What does registration entail? The registration process requires the issuer to file a registration statement with the SEC before the offer or sale of the securities, and to deliver a prospectus to potential purchasers that provides them with sufficient information to make an informed investment decision. Public companies must register shares and disclose company information as a matter of course.

But private companies with equity compensation plans must either register the shares or offer them subject to an exemption from registration. Private companies must also bear in mind that if they have assets exceeding $10 million and 500 or more shareholders—which currently includes option holders—they will become de facto public companies subject to the reporting and disclosure requirements of the Securities Act. (As of mid-2007, the Securities and Exchange Commission was considering a change that would exclude the holders of stock options from this number.)

Qualified Retirement and Stock Bonus Plans: Participation Interests

A plan participant's interest in a tax-qualified retirement plan, such as an ESOP, stock bonus plan, or profit sharing plan, that is funded entirely by employer contributions does not constitute a security because such a plan is not both voluntary and contributory. Consequently, a plan sponsor's offer of such interests to employees is not subject to the securities law registration requirements. However, if an employer allows employees to buy employer stock in voluntary contributory plans (such as a 401(k) plan), the SEC generally will consider such interests to be securities. Although the courts have found the securities laws apply only where the plans are both voluntary and contributory, the SEC has taken the position that only voluntary and contributory plans that offer employer stock as an investment option must take the specific step of registering their shares. However, if employer stock is offered by a 401(k) plan solely as a matching contribution made by the employer, those shares will be exempt from registration.

The SEC has found that participation interests in noncontributory ESOPs and stock bonus plans generally do not require registration insofar as no sale is involved. In some cases, closely held companies want to sell stock to their employees through a 401(k) plan and/or ESOP, or solicit employees to move money already in their 401(k) or profit sharing accounts into an ESOP to buy employer stock. Securities law is unclear as to whether this requires a registration if the various exemptions from securities laws are not met.

Registration Exemptions Under the Securities Act

The following discussion summarizes the registration exemptions available under the Securities Act to qualified and nonqualified plans offering employer stock:

1. Exemption of Small Securities Offerings: Regulation A

Regulation A provides for an exemption that acts like simplified registration. It permits issuers to make public offerings of up to $5 million worth of securities in any 12-month period without registration under the Securities Act. Shareholders may use Regulation A to resell up to $1.5 million of securities in any 12-month period. A company using Regulation A must file an offering statement consisting of a notification to potential buyers, an offering circular disclosing financial issues for the offer, and exhibits with the SEC for review. The offering circular is similar in content to a prospectus, but the financial statements are simpler and do not need to be audited. There are no Exchange Act reporting obligations after the offering unless the company has more than $10 million in total assets and 500 or more shareholders.

All types of companies that do not report under the Exchange Act may use Regulation A, except "blank check" companies, those with unspecified businesses, and investment companies registered or required to be registered under the Investment Company Act of 1940. A principal advantage of a Regulation A offering is that it allows a company to test the waters to determine if there is adequate interest in its securities before it incurs the legal, accounting, and other expenses associated with filing an offering statement with the SEC. Under Regulation A, companies can advertise before filing an offering statement, but they cannot solicit or accept money until the SEC has completed its review of the filed statement and investors have been provided with the prescribed offering materials.

2. Private and Limited Offerings: Regulation D

Regulation D, which includes Rules 504, 505, and 506, provides a number of exemptions for small offerings and private placements.

These are among the exemptions sometimes used for equity compensation plans. In each case, the issuer may not use public solicitation or advertising to market the securities and the purchasers receive "restricted" securities, meaning that they may not sell the securities without registration or pursuant to an applicable exemption.[1] Notwithstanding an exemption, the issuer must provide sufficient information to investors to avoid violating the anti-fraud provisions of the securities laws, which are discussed further below.

- Rule 504 provides an exemption for public offerings by issuers for the offer and sale of up to $1 million of securities in a 12-month period. This exemption may be used if the issuer is not a "blank check" company and is not subject to Exchange Act reporting requirements.
- Rule 505, best-known of the Regulation D exemptions, provides an exemption for offerings to any number of "accredited investors" (defined below) and to as many as 35 non-accredited investors when the offers and sales of securities are not in excess of $5 million in any 12-month period. Stock options are counted toward the dollar limit during the entire time they are exercisable. Non-accredited investors must be provided with disclosure documents that generally are the same as those used in registered offerings.
- Rule 506 is a safe harbor for the private offering exemption. This exemption applies to public offerings made to any number of accredited investors and up to 35 other purchases by sophisticated non-accredited investors, without a limit on the amount of money that may be raised. Non-accredited investors must be provided with disclosure documents that generally are the same as those used in registered offerings.

Although companies using Regulation D exemptions are not required to register their securities, after their first securities sales

1. "Restricted securities" that cannot be freely resold are distinct from "restricted stock," which is a form of equity compensation.

they must file Form D, a brief notice that discloses the names and addresses of the company's owners and stock promoters.

3. Accredited Investor Exemption

Offers and sales of securities to accredited investors are exempted from registration when the total offering price is less than $5 million. Like the Regulation D exemptions, this exemption does not permit any form of advertising or public solicitation. An accredited investor is:

- a bank, insurance company, registered investment company, business development company, or small business investment company;
- an employee benefit plan, if a bank, insurance company, or registered investment adviser makes investment decisions, or the plan has total assets in excess of $5 million;
- a charitable organization, corporation, or partnership with assets exceeding $5 million;
- a director, executive officer, or general partner of the company selling the securities;
- a business in which all the equity owners are accredited investors;
- a natural person with a net worth of at least $1 million;
- a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or
- a trust with assets of at least $5 million, not formed to acquire the securities offered, and whose purchases are directed by a sophisticated person.

4. Exemption for Sales of Securities Through Employee Benefit Plans: Rule 701

Rule 701 was adopted by the SEC to allow privately held companies to offer and sell securities without registration if they are issued to employees as compensation pursuant to written compensatory benefit plans and written compensation contracts. This exemption is often used for equity compensation plan offerings. Issuers may use Rule 701 if they are not subject to the reporting requirements of the Exchange Act, and are not investment companies that must be registered under the 1940 Investment Act.

The aggregate sales price or the amount of securities sold in reliance on Rule 701 during any consecutive 12-month period must not exceed the greater of: (1) $1 million; (2) 15% of the total assets of the issuer (or issuer's parent in cases where the issuer is a wholly owned subsidiary and the securities represent obligations that the parent fully and unconditionally guarantees), as determined on the issuer's most recent balance sheet date; or (3) 15% of the outstanding amount of securities of that class, as determined on the issuer's most recent balance sheet date.

An issuer may sell at least $1 million of securities under this exemption, no matter how small it is. If more than $5 million in securities are expected to be sold in a 12-month period, financial information and risk factors together with a copy of plan-related documents must be disclosed to employees prior to sale in order to satisfy Regulation A disclosure requirements. If such disclosure has not been provided to all investors before the sale, the issuer will lose this exemption.

Volume limitations. The volume limitations of Rule 701 are based solely on actual sales or, as in the case of options, the amounts to be sold. For equity incentives such as restricted stock and compensatory stock purchases, the calculations are made as of the transaction date. For deferred compensation and similar plans, the determination is based upon the date of an irrevocable election to defer compensation. For options, the calculation is made as of the grant date without regard to whether the option is currently exercisable or vested. For securities exchanged solely for consultant and employee services, the value of services is measured by reference to the value of the securities issued rather than to the employee's salary or the consultant's invoice.

5. Exemption of Intrastate Offerings

One well-known exemption applies to securities that are sold entirely within a single state or territory (intrastate offerings). To qualify for this exemption, an issuing company must be incorporated in the state where it is offering the securities, carry out a significant amount of business in that state, and make offers and sales of securities only to residents of that state. To do substantial business in the state, a company must have at least 80% of its gross from the state, at least 80% of its assets located in the state, its principal office located within the state, and at least 80% of the proceeds of the offering used in the state. There is no fixed limit on the size of the offering or the number of purchasers. Practically speaking, however, only very localized businesses can rely on this exemption. Also, it must be remembered that intrastate offerings may be subject to registration requirements under state blue-sky laws.

Form S-8: What If an Exemption from Registration Is Unavailable?

The SEC requires only voluntary contributory employee benefit plans that offer employer stock as an investment option to be registered under the Securities Act. Registration of shares in such plans is intended to afford plan participants a degree of protection insofar as the employer maintains a direct financial interest in soliciting employee contributions to the plan. Form S-8 is a much-simplified federal registration statement available to issuers that are subject to the reporting requirements of the Exchange Act. It may be used only in connection with a compensatory transaction from an employee benefit plan that covers employees of the employer maintaining the plan and/or the employees of its parent and subsidiary corporations.

Form S-8 consists of a prospectus and a registration statement. The prospectus may incorporate a summary plan description, provided the document is dated and clearly identified as constituting part of the prospectus. Other documents may be incorporated by reference in a Form S-8 registration, including the employer's filings made under the Exchange Act with respect to employer securities. Securities registered in this manner are not "restricted securities" for purposes of resale by plan participants other than affiliates.

Registrants that are ineligible to use Form S-8 must use Form S-1. However, extensive disclosure requirements, preparation costs, and annual updating requirements often render use of this form an impractical alternative.

Penalties for Registration Noncompliance

The penalties for failure to comply with the Securities Act registration requirements where an exemption is not available can be severe. A failure to register a security that is not otherwise subject to exemption entitles the purchasers to rescind the transaction and obtain a refund of their purchase price or receive damages. Also, if a registration statement contains a material misstatement or omission, the issuer is automatically liable.

Restricted Securities and the Registration Requirement Upon Resale

A distribution of a security held by the plan to a participant or beneficiary generally does not require registration. Once distributed by the plan, however, the securities may be "restricted," i.e., subject to registration upon resale. Restricted securities generally describe shares issued by a company before its initial public offering (IPO).

Until 90 days after a company's IPO, resales of restricted securities are limited to persons who are not or have not been affiliates of the company for at least three months before the sale. In such case, the seller must have held the restricted securities for at least two years. There is one important exception: 90 days after the shares become subject to the reporting requirements of the Exchange Act, if the stock was granted under Rule 701, option shares issued to non-affiliates can be sold without regard to Rule 144 (except for the manner-of-sale provisions), and affiliates can sell their shares pursuant to Rule 144 (see below), but without regard to the prior holding period.[2] So as not to adversely affect the value of recently issued public shares, it is quite common for companies that issue equity grants in connection with their IPOs to "lock up" or restrict key employees (generally, "affiliates") from selling their shares well beyond the 90-day period imposed under Rule 144, which is described below. A related issue concerns the value of securities that are issued before an IPO. The existence of "cheap stock" is briefly addressed below.

Rule 144 Safe Harbor Exemption for Resale of Securities

Rule 144 of the Securities Act provides a safe harbor exemption from registration for people who want to resell unregistered shares, including those acquired through an equity compensation plan. Rule 144 applies both to sales of "restricted securities" by any person, including plan participants and beneficiaries (unless an applicable registration exemption applies), and to sales of any securities, whether restricted or unrestricted, by affiliates. Rule 144 defines an affiliate as "a person that directly, or indirectly, through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer."

To obtain the benefit of the exemption, the securities holder must comply with each of Rule 144's five basic requirements:

- *Holding period:* A one-year holding period from the date of acquisition is required for restricted securities. (This may be disregarded if an SEC exemption applies.)
- *Publicly available information:* Required information about the company must be publicly available for at least 90 days before resales.
- *Stock sales:* The stock must be sold through brokers or directly to a market-maker (such as an investment banker).

2. As we went to press in mid-2007, the SEC was considering several changes to Rule 144, including the holding periods.

- *Filing requirements:* A Form 144 must be filed with the SEC at the time of any sale, with an exception for sales of fewer than 500 shares for less than $10,000.
- *Volume limitation:* The amount of securities sold in any three-month period may not exceed the greater of: (1) 1% of the outstanding securities; or (2) the average weekly reported volume of trading in these securities for the four calendar weeks preceding the week of the sale.

The SEC has permitted non-affiliate participants to resell securities without registration or exemption from registration where the securities are actively traded, the number of securities involved is relatively small (normally less than 1% of outstanding shares), and the issuer is a reporting entity under the Exchange Act.

The Exchange Act

The Registration Requirement

The Exchange Act mandates that certain issuers comply with additional registration and reporting requirements and trading restrictions. Pursuant to Section 12(g) of the Exchange Act, if an issuer has a class of equity securities held of record by 500 or more persons and the issuer has total assets exceeding $10 million as of the last day of the issuer's fiscal year, the equity securities must be registered under the Exchange Act. Employers that sponsor stock plans will be required to register employer stock and satisfy all reporting requirements of the Exchange Act if Section 12(g)'s criteria apply.

Section 12h-1: Registration Exemption for Employee Benefit Plans

Employee benefit plans themselves are generally exempt from the Exchange Act's registration requirements under Section 12h-1, which exempts participation interests in employee stock bonus, stock purchase, pension, profit-sharing, retirement and other employee benefit plans in which assets are not transferable by the holder (except in the event of death or mental incompetence).

Periodic Reporting

Issuers that have registered their securities under the Securities Act must comply with various periodic and specialized reporting requirements under the Exchange Act as summarized below, but they are not required to formally register under the Exchange Act.

- *Annual reports:* An annual report must be filed on Form 10-K (the form used by most reporting companies), or on Form 11-K (a special annual report for employee stock purchase, savings, and similar plans), as applicable. If a plan registers its participation interests under the Securities Act, the plan will generally be required to file annual reports on Form 11-K. In some circumstances, separate annual reports are not required if the plan combines its Form 11-K with the employer's Form 10-K.
- *Quarterly reports:* Unaudited financial statements and certain additional information must generally be provided within 40 days after the end of each of the first three fiscal quarters for accelerated and large accelerated filers, and 45 days for all other filers. This filing is made on Form 10-Q.
- *Executive compensation disclosures:* Executive compensation disclosure rules apply to proxy statements, periodic reports, and other filings under the Exchange Act, and to registration statements under the Securities Act. The current rules generally require tables disclosing executive pay that furnish details on various types of compensation. The issuer is required to include tables with information on its equity compensation plans.

In 2006, the SEC finalized executive compensation disclosure rules that require disclosure of more details in order to satisfy the registration and reporting requirements. For instance, the rules improve the previous tabular requirements and supplement them with a narrative disclosure section that discusses the material factors underlying compensation policies and decisions reflected in the data presented in tabular form. More detailed disclosures are included in: (1) a Summary Compensation Table that covers compensation, including equity awards, granted during the last fiscal year and two preceding ones; (2) Outstanding Equity Awards at Fiscal Year-End Table and the Options Exercises and Stock Vested tables, which show holdings of equity-related interests that relate to compensation or are potential sources of future gains; and (3) a Retirement Plan and Post-Employment Disclosure Table, which discloses retirement and other post-employment benefits. The reporting requirements are discussed further in the chapter on public company issues.

Specialized Reporting

- *Ad hoc reports:* Form 8-K must be filed whenever events of material importance to security holders, including events relating to executive officer compensation, have occurred. Because of the new executive compensation disclosure rules, the number of Form 8-Ks to be filed each year relating to executive and director compensation matters will likely be reduced.
- *Acquisition reports:* Where a plan acquires beneficial ownership of more than 5% of a class of an issuer's securities registered under the Exchange Act, it must report that ownership by filing a Schedule 13G or Schedule 13D. These filings contain background information about the beneficial owners as well as their investment intentions.
- *Insider reports:* Certain corporate insiders are required under the Exchange Act to report their transactions involving the company's equity securities to the SEC. The reports include information relating to their securities holdings (that are held either inside or outside a plan in which the insider participates), and provide a means for the company to identify and recover profits an insider realizes from the purchase and sale of a company security within a six-month period ("short swing" profits). For this purpose, insiders include every officer, director, and beneficial owner of more than 10% of a company's stock (whether of the sponsoring employer of another company). Many routine plan transactions are exempt from reporting, with the exception of volitional dispositions of employer equity securities and intra-plan transfers of employer equity securities.

Anti-Fraud Rules

Specific state and federal securities rules require disclosure of various categories of information, including objective discussions of risks, the financial condition of the firm, officers' and directors' salaries, as well as other information an employee would need to know to make an informed choice. All securities transactions, including exempt transactions, are subject to the anti-fraud provisions.

The anti-fraud rules of the Securities Act and the Exchange Act prohibit the use of fraud, any manipulative practice, or material misstatement or omission in connection with the offer and sale of securities, whether oral or written. This prohibition of fraud applies to all securities, regardless of whether they have been registered, including plan participation interests that are securities and employer stock held in an employee benefit plan. To ensure compliance with the anti-fraud rules, all "material aspects" of the transaction must be accurately disclosed. These rules apply to employee benefit plans and to plan participants even though the securities that are involved may themselves be exempt from registration.

Proxy Voting and the Sarbanes-Oxley Act of 2002: Plans as Investors

A company with securities registered under the Exchange Act must comply with the SEC proxy rules whenever a shareholder vote is required on corporate matters, including when a publicly held company institutes a new equity compensation plan or modifies an existing plan. The proxy rules require that the company provide a proxy statement to its shareholders, together with a proxy card when soliciting proxies. Proxy statements address management and executive compensation as well as matters that require shareholder votes. If the company is not soliciting proxies but will take a vote on a matter, the company must provide to its shareholders an information statement similar to a proxy statement.

As investors in company stock as well as in other types of securities, qualified employee benefit plans such as ESOPs and 401(k) plans will receive and act upon proxy statements. The securities laws that affect plans in their role as investors3 deal with corporate issues whose discussion, though important, is beyond the scope of this chapter.

State Blue-Sky Laws

The federal and state governments each have their own securities laws and regulations. An issuer must comply with both sets of laws. A particular securities offering that is exempt from registration under the federal securities laws will not necessarily likewise be exempt from registration under state securities laws. Each state has its own securities laws and applicable exemptions. Thus, offerings that are exempt from the provisions of the federal securities laws may still be subject to the notice and filing requirements of various state securities laws.[4] The application of state securities laws to equity compensation plans is discussed in more detail in the NCEO's book *Selected Issues in Equity Compensation.*[5]

Thirty-nine states have blue-sky laws that comply with the Uniform Securities Act, which is partly based on federal law. While some states track federal exemptions; others do not. Explaining each state's rules is beyond the scope of this work, but there are some general patterns:

- States with exemptions similar to Rule 701 are the exception rather than the rule. Those such as California that have such exemptions generally have some additional requirements. State registration of offerings may be needed if the limited-offering exemptions do not apply.

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3. These issues, which are numerous, include proxy voting by fiduciaries managing plan assets, proxy solicitations by pension funds, the Sarbanes-Oxley provisions prohibiting certain types of executive compensation, and requiring forfeiture of executive compensation in certain circumstances.
4. This does not mean a company has to comply with every state's laws. Rather, they apply in those states in which the employer is actually making an offering.
5. Scott Rodrick, ed. (Oakland, CA: NCEO, 2007), updated annually.

- Most states have limited-offering exemptions for sales to up to 35 non-accredited investors and an unlimited number of accredited investors. Unless the non-accredited investors are deemed to be sophisticated, issuers offering such securities must believe the offering is suitable for these purchasers in terms of their overall financial conditions, which include other securities holdings.

The North American Securities Administrators Association (NASAA), in conjunction with the American Bar Association, has developed the Small Company Offering Registration (SCOR), a simplified "question and answer" registration form that companies also can use as the disclosure document for investors. SCOR was primarily designed for state registration of small-business securities offerings conducted under SEC Rule 504 for sales of securities up to $1 million. Currently, more than 45 states recognize SCOR. To assist small business issuers in completing the SCOR Form, NASAA has developed a detailed "Issuer's Manual" that is available through NASAA's Web site at www.nasaa.org.

In addition, a small company can use the SCOR Form, called Form U-7, to satisfy many of the filing requirements of the SEC's Regulation A exemption for sales of securities of up to $5 million, since the company may file it with the SEC as part of the Regulation A offering statement.

To assist small businesses whose offerings include several states, many states coordinate SCOR or Regulation A filings through a program called regional review. Regional reviews are available in the New England, Mid-Atlantic, Midwest, and Western regions.

Cheap Stock in Pre-IPO Companies

Closely held companies that intend to go public should assess early in their planning stages what their potential securities law issues might be in an IPO. Perhaps the most common securities law concern in pre-IPO companies relates to the existence of what the SEC refers to as "cheap stock."

Companies that go public normally sell their shares at a premium in an IPO when compared to the price at which employee equity awards were granted or stock was sold to employees before the IPO. The reason for this is that once public, the company's stock has a ready market, making it more liquid and thus more valuable. The new equity raised through the IPO also adds value to the company's shares.

Any company contemplating an IPO must consider its ability to attract and retain key talent through this critical period of development. The promise of large monetary gains from stock compensation cashed out after an IPO often substitutes for a significant portion of current salary that would otherwise be required to attract and retain the right set of employees. The temptation for a company to discount the pre-IPO value of its shares in an effort to maximize post-IPO gains may be great under such factual circumstances.

When Does "Cheap Stock" Likely Exist?

If the company discounts its shares too much before the IPO, when compared to the IPO offering price, the SEC, when reviewing the company's IPO registration statement, may treat the pre-IPO issuance as "cheap stock" and require the company to restate its financials, which in turn may delay the effective date of the IPO and adversely affect the IPO stock price. For example, if an IPO is priced at $12, and the company issued awards a year before the IPO at $2, the SEC may audit the financials and find that the true fair market value of the shares was some other number, say $7. It then will require that this additional $5 per share value be included in the financial statement and treated as a compensation cost.

If the earnings per share are reduced as a result of the restatement of financials, this recalculation may result in a reduced IPO share price and consequent loss of equity funds for the company. The company may also be required by the SEC to incur the additional expense of recirculating its prospectus because the financial statements in the initial prospectus were unacceptable.

Companies that are planning IPOs should recognize that the SEC will scrutinize plans issuing stock to employees shortly before the IPO at prices substantially below the IPO price. A company that anticipates cheap stock problems may want to avoid unnecessary delay of its IPO by first consulting with the Office of the Chief

Accountant in the Division of Corporate Finance at the SEC for advice. The company may also want to consider retaining an investment banker to provide an independent appraisal of the fair market value of the company's stock at the grant date. At the very least, a company planning an IPO must be mindful of the factors described in the section on valuation in the introductory chapter of this book, along with the regulations for valuation of stock for deferred compensation purposes, if it desires to avoid the potential problems associated with the existence of cheap stock.