Technical Line

Financial reporting obligations under SEC Rule 701 for private companies that issue equity compensation

What you need to know

• As companies remain private longer and continue growing, they often pass the $5 million threshold for the aggregate sales or issuances of securities to employees and other covered persons within a 12-month period, thus triggering the requirement under SEC Rule 701 to provide financial statements and other disclosures to participants in the exempt offering.

• Interim financial statements also may be required to make sure the date of the most recent financial statements is never more than 180 days before the sale of securities in reliance on the Rule 701 exemption.

• If a private company fails to timely provide participating investors with the disclosures required under Rule 701, it loses the registration exemption for the entire offering made during the 12-month period in which it exceeds the $5 million threshold.

Overview

A private company that sells or issues more than $5 million in equity securities to employees and other covered persons (i.e., directors, officers, consultants, advisers and their family members) during a 12-month period must first provide financial statements to all recipients of the securities sold or issued during that entire period to maintain the registration exemption under Rule 701 of the Securities Act of 1933 (Securities Act).

As many companies remain private longer and continue growing, they are increasingly triggering the threshold under Rule 701 to provide financial statements to participants in the exempt offering. Additionally, the Jumpstart our Business Startups Act allowed issuers to
exclude persons who receive securities as equity compensation under the Rule 701 exemption when calculating the number of holders of record to determine whether registration is triggered under Section 12(g) of the Exchange Act of 1934 (Exchange Act). Thus, it is important for private companies to maintain compliance with Rule 701.

When offering securities, a company must file a registration statement with the Securities and Exchange Commission (SEC), unless it's exempted from doing so. Rule 701 provides an exemption for private companies (i.e., those not subject to an ongoing reporting obligation under Section 13 or 15(d) of the Exchange Act of 1934, including voluntary filers) allowing them to offer stock-based compensation (e.g., stock options, restricted stock awards, employee stock purchase plans) without the liabilities and regulatory burden that come with Securities Act registration.

We are finding that private companies may not be aware of the financial reporting obligations under Rule 701 and may not want or be able to provide financial statements, even confidentially, to participants in the offering for competitive reasons. However, a company that doesn't comply with this requirement loses its Rule 701 exemption and must register the offering with the SEC, unless the company can qualify the sale or issuance of securities in excess of $5 million under any other registration exemption (e.g., Rule 504 of Regulation D). Noncompliance could expose companies and their management to enforcement actions by the SEC.

**Key considerations**

**Calculation of aggregate sales within a 12-month period**

Companies must measure the aggregate sales of securities to employees and other covered persons within the 12-month period based on actual consideration received in exchange for the securities (i.e., cash paid, notes issued, debt canceled and fair value of consideration received (other than services) if contemporaneous bona fide sales data is unavailable). When employees receive securities upon vesting of restricted stock awards without making any payments, such securities must be measured at the fair value of the underlying securities upon issuance of the restricted stock awards (i.e., the grant date) when calculating the aggregate sales of securities for the 12-month period. For stock options, the exercise price is used in the calculation.

**Financial statement requirements under Rule 701**

When the obligation to provide financial statements is triggered under Rule 701, companies are required to provide financial statements following the same requirements applicable to exempt offerings under Regulation A. That is, they generally must provide financial statements for the two most recently completed fiscal years or the period during which they have been in existence if it is shorter. These financial statements must include consolidated balance sheets and statements of income, cash flows and changes in stockholders’ equity. Interim financial statements also may be required to make sure that the date of the most recent financial statements is never more than 180 days before the securities are sold or issued.

For example, if Rule 701 disclosures are required, a company with a year ended 31 December 2016 would need to provide first-quarter financial statements before selling or issuing securities in reliance on the exemption after 29 June 2017 but before 28 September 2017. The company would need to provide second-quarter financial statements before selling or issuing securities after 27 September 2017 but before 28 December 2017. It would need to provide third-quarter financial statements before selling or issuing securities after 27 December 2017 but before 29 March 2018.
Companies may elect to follow the financial statement requirements for either Tier 1 or Tier 2 of Regulation A as required in Part F/S of Form 1-A regardless of the offering amount. The Tier 1 financial statement requirements are less onerous, since companies do not have to prepare financial statements in accordance with Regulation S-X or obtain an audit. When a private company elects to follow the Tier 2 financial statement requirements, it also must, at a minimum, comply with the financial statement requirements applicable to smaller reporting companies under Article 8 of Regulation S-X. Both Tier 1 and Tier 2 financial statement requirements allow interim financial statements to be condensed in accordance with Rule 8-03(a) of Regulation S-X.

In addition, private companies that trigger the Rule 701 disclosure requirements must evaluate whether financial statements of acquired entities and related pro forma information are required for any significant business combinations or operating real estate acquisitions.

Domestic private companies must prepare their financial statements under US GAAP to comply with the Rule 701 financial reporting obligation. However, foreign private issuers (FPIs) subject to the Rule 701 disclosure obligation may prepare their financial statements under their local GAAP, US GAAP or IFRS as issued by the International Accounting Standards Board (IASB). FPIs must provide a reconciliation to US GAAP in accordance with Item 17 of Form 20-F if their financial statements are prepared under an accounting framework other than US GAAP or IFRS as issued by the IASB.

### Audit requirements

Companies may provide unaudited annual financial statements to comply with the Rule 701 disclosure obligation under the Tier 1 approach unless audited financial statements are available and the audit was conducted in accordance with US generally accepted auditing standards (GAAS) or the standards of the Public Company Accounting Oversight Board (PCAOB).

When a private company elects the Tier 2 approach, it must provide audited annual financial statements. While the SEC permits that audit to be conducted in accordance with either US GAAS or PCAOB standards, the American Institute of Certified Public Accountants requires any audit performed for non-issuers under PCAOB standards to also comply with US GAAS. In those cases, the auditor’s report must comply with Statement of Auditing Standards (SAS) 131 and refer to both sets of standards.

### Timing for providing financial statements

Rule 701 requires companies to provide financial statements and other disclosures (i.e., a summary of the compensation plan and information about investment risks) within a reasonable period of time before the securities sale (or grant) date. If the sale of securities involves stock options or other derivative securities, companies must deliver the financial statements within a reasonable time before the date of the stock option exercise or conversion.

### How we see it

Due to uncertainty about the timing of exercise of vested stock options, companies should update their financial statements throughout the year and be ready to comply with the Rule 701 financial reporting obligation once option holders provide notice of intent to exercise.

However, when a derivative security (e.g., a restricted stock unit) is not converted or exercised but is settled upon the satisfaction of a condition (e.g., length of employment, performance targets), the company must deliver the financial statements within a reasonable time before the grant date of the award.
If a private company fails to timely provide the financial statements and other disclosures to all investors in the Rule 701 offering, it loses the registration exemption for the entire offering made during the 12-month period in which it exceeds the $5 million threshold.9

**How we see it**

As a best practice, companies that use the Rule 701 exemption should implement robust controls to track the volume and expected timing of sales or grants under their equity compensation plans, to avoid unintentional noncompliance with its disclosure requirements.

**Method of delivering financial statements**

Rule 701 does not specify how a private company should deliver financial statements and other required disclosures to employees and other covered persons participating in equity compensation plans. Companies may use electronic delivery methods, such as an email or a secured virtual data room, to furnish the information.10 Voluntary filers may refer offering participants to their financial statements filed with the SEC.

**How we see it**

To minimize the risk of disclosing confidential information to competitors, private companies may consider requiring employees who participate in equity compensation plans to sign confidentiality agreements.

**Endnotes:**

1 Companies may choose a fixed (e.g., fiscal year, calendar year) or rolling 12-month period to calculate the amount of securities sold under the Rule 701 exemption, but they must consistently use the period they choose (Question 271.06 in the SEC staff Compliance and Disclosure Interpretations (C&DI) of Securities Act rules).
2 Rule 701 of the Securities Act, §230.701 — Exemption for offers and sales of securities pursuant to certain compensatory benefit plans and contracts relating to compensation.
3 EY publication, Looking behind the declining number of public companies – An analysis of trends in US capital markets.
4 A voluntary filer is a company that is not required under Section 13(a) or 15(d) of the Exchange Act to file periodic reports with the SEC but voluntarily files these reports.
5 C&DI Question 271.21.
6 SAS 131, Amendment to Statement on Auditing Standards No. 122 Section 700, Forming an Opinion and Reporting on Financial Statements.
7 A derivative security is a security that derives its value from one or more underlying securities. Examples include warrants and stock options.
8 C&DI Question 271.24.
9 C&DI Question 271.12.
10 C&DI Question 271.15.