

Stock Options of US Private Companies

Start-up companies tend to reward their directors, officers and employees with stock options. In the US most do so through formal incentive stock option plans which are structured as either incentive stock options (ISOs) or nonqualified stock options for tax treatment purposes. Although tax issues are important, securities laws should not be ignored when issuing stock options. This article provides a general overview of Rule 701 which private companies (domestic and foreign) may rely on when issuing stock to US residents.



Stock options and the underlying stock are securities. Both the options and the shares of stock subject to option must be registered under the federal and applicable state securities laws unless an exemption from registration can be found. Rule 701 under the Securities Act of 1933 (the “**1933 Act**”) provides a federal exemption from registration for benefit plan securities issued by private company issuers.

In order to rely on Rule 701 the following requirements must be met:

- **Non-Reporting.** The company must not be a reporting issuer pursuant to section 13 or 15(d) of the *Securities Exchange Act of 1934* (the “**1934 Act**”):
- **Qualified Recipients.** The issuances must be made to qualifying individuals – generally, employees, directors, general partners, trustees (where the issuer is a business trust), officers, or qualifying consultants and advisors, and their family members who acquire such securities from such persons through gifts or domestic relations orders of the company or its subsidiaries. *Rule 701 does not exempt issuing shares to companies, or to non-employees who help in fund raising or promotion of the company.*
- **Amount Caps.** The amount of securities issued is less than one of several limits, during any 12-month period:
 - the aggregate sale price of shares granted cannot exceed \$1,000,000; or
 - the number of shares granted cannot exceed 15% of the total assets of the issuer; or
 - the number of shares granted cannot exceed 15% of the outstanding common stock (including any preferred stock on an as-converted basis).
- **Informational Requirements:** Optionees must be provided with a copy of the plan or agreement to issue the securities which must be in writing (incentive, stock option, stock appreciation or stock purchase plan, an individual incentive, option or similar agreement, or an employment agreement). Additional disclosure must be provided if the aggregate sales price in any 12-month period (measured for this purpose as the sale dates rather than the grant dates) exceeds \$5,000,000. This additional disclosure material includes a summary of the material terms of the plan, risks associated with investment, and current financial statements.)

Offers and sales pursuant to Rule 701 are not integrated with those under other exemptions, so the 35 non-accredited investors allowed under Regulation D will not be diminished by issuing options covered by Rule 701.

Issues to Keep in Mind

Blue Sky. A company must also ensure it complies with state regulations when issuing stock options under Rule 701. Rule 701 offerings are automatically exempt from state filing requirements in a number, but not all states. You will need to rely on an available state exemption where the recipient of the stock option resides. State requirements can vary considerably. For instance, New York and New Jersey require pre-issuance filings with their state regulators. California regulators have substantive rules on the terms of options and grants to employees and consultants, such as minimum vesting schedules and pricing terms. These rules in California are currently under review). Before issuing options you should review the applicable state laws for compliance.

Limit Number of Shareholders. A private company may inadvertently become a public company if the compensation benefit plan adopted increases the number of shareholders to 500 or above. Under the *1934 Act*, any company with more than 500 shareholders is subject to public reporting requirements as well as the SEC's proxy and insider-trading rules (no-action relief may be possible from the 500 shareholder limit).

Issuance of Public Debt Removes Eligibility to Rely on Rule 701. Rule 701 offerings are available only for companies that are not subject to public reporting obligations. If a company files an exchange offer registration statement it becomes legally subject to reporting requirement to at least until the end of its fiscal year. (Thereafter, the issuer typically is required by its bond indenture to continue to file periodic reports, but may not be legally subject to public reporting requirements). Rule 701 is not available during the period in which a company is legally subject to reporting obligations; however, offerings to employees registered on Form S-8 can be made.

Taxation. Two types of stock options receive special treatment under the Internal Revenue Service Code (“**Code**”): incentive stock options (ISOs) and options under an employee stock purchase plan (ESPP) that is qualified under section 423 of the Code. There is no recognition of income on the option grant or on the exercise of the option under either of these programs, provided that certain conditions under sections 422 and 423 of the Code are satisfied. Additionally, if the stock is disposed of after completion of the statutory holding period, any appreciation will be taxed as capital gain. Non-ISO options and non-ESPP options are taxed at the time of grant.

To qualify as an ISO, stock options must be issued only to an employee and must have an exercise price not less than the fair market value on the date they were granted. The company cannot grant the employee ISOs exercisable for more than \$100,000 in stock in any year.

Resale of Private Company Stock Options

Securities sold pursuant to Rule 701 are "restricted securities" and can be resold only pursuant to an effective registration statement, unless an exemption from the registration requirements is available.

Ninety days after the company becomes a reporting issuer under the *1934 Act*, securities issued under Rule 701 may be resold by persons who are not affiliates (as defined by Rule 144 of the *1933 Act*), without compliance with manner of sale provisions, notice requirements, current public information requirements, or volume limitations of Rule 144, and by affiliates without compliance with paragraph (d) of Rule 144.

Other Exemptions

In addition to Rule 701, private companies may rely on a number of other exemptions from the registration requirements of the *1933 Act* when issuing stock options. These exemptions include:

- Regulation D:
 - Rule 506,
 - Rule 505;
- Section 4(2);
- Other sundry exemptions.

It is always wise to check with your legal counsel before implementing or issuing any option plan. Looking for an available exemption from registration after the fact can hold some nasty surprises.

Consequences of Securities Law Non-Compliance

Failure by a company to comply with An optionee who exercised his or her option would have the right to rescission. The company would be required to repay to the optionee any amounts paid for acquisition of the shares. These amounts may be nominal or substantial and depending on the fortunes of the company the cash demands could be material.

There is also the possibility of state or federal enforcement actions against the company or those individuals responsible for the failure to comply. An enforcement action is independent to the right of rescission.

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