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Employee Ownership of Registration-Exempt Company Securities: Proposals to Reform Required Corporate Disclosures (Section 507 of S. 2155, S. 488, H.R. 1343, and Section 406 of H.R. 10)

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Introduction

A major statutory mission of the SEC is investor protection, which involves requiring companies that offer securities to the public to disclose meaningful financial and other information about themselves to both existing and potential investors. To that end, under the Securities Act of 1933 (the Securities Act), a company that offers or sells its securities to the public is required to register them with the SEC. This securities registration process requires that the company that is issuing the securities disclose key facts, including a description of the company's assets and business; a description of the security being offered for sale; information on company management; and financial statements that have been certified by independent accountants. SEC registration can entail significant costs that can arguably be disproportionately burdensome to small and medium-sized businesses and startups.

Rule 701

Adopted by the SEC in 1988, Rule 701 of the Securities Act provides an exemption from such

registration requirements to nonpublic companies, including startups that offer their own securities (including stock options and restricted stock) as part of formal written compensation agreements to employees, directors, general partners, trustees, officers, specified advisers, and consultants.

Certain conditions must be met for eligibility, chiefly: Total sales of stock to the aforementioned corporate entities during a 12-month period cannot exceed the greater of $1 million; 15% of the issuer's total assets; or 15% of all the outstanding securities of the class of securities being offered. In addition, during any 12-month period, if the sale of securities, including stock options to the aforementioned corporate personnel, exceeds $5 million, which may occur under the latter two 15% scenarios, the company must provide the employee/investors with additional information on a recurring basis, including risk factors, copies of the plans under which the offerings are made, and certain financial statements.

Small and medium-sized and startup companies often compete for personnel by offering company stock options and stock with their potential for future employee wealth creation. From the perspective of the corporation, there is some research that has linked employee ownership of company stock with increased employee productivity. Some reporting, however, has found that growing numbers of nonpublic startups have been maintaining their nonpublic status for longer periods of time as they grow, increasingly bumping up against the $5 million threshold under Rule 701, threatening to trigger the aforementioned disclosure and reporting requirements.

Current Legislation

Intended to reduce the number of companies hitting the $5 million threshold, Section 507 of S. 2155, as passed by the Senate; S. 488, as reported by the Senate Banking, Housing, and Urban Affairs Committee; and H.R. 1343, as passed by the House, would increase the amount of aggregate securities sales to corporate personnel over any 12-month period from $5 million to $10 million before the additional disclosure requirement is triggered. Section 406 of H.R. 10, as passed by the House, would increase the amount to $20 million. All would also require the SEC to index the new figure for inflation every five years. In the 114th Congress, language identical to S. 488 and H.R. 1343 passed the House as Title I of H.R. 1675.

Supportive arguments for such legislation made by the U.S. Chamber of Commerce, a major business trade group, include the contention that it would (1) encourage more privately held companies to provide company stock to their employees, as many are reportedly wary that rival firms could exploit the information (e.g., trade secrets); and (2) better align the $5 million figure (established in 1999) with its current value after adjusting for inflation. In addition, the generally pro-investor-protection North American Securities Administrators, a group of state and provincial securities regulators, with investor protection concerns, testified that legislation similar to S. 488, H.R. 1343, and Section 406 of H.R. 10 would not affect "mom and pop" retail investors outside of the companies, since companies with Rule 701 exemptions can only issue stock to company-affiliated personnel.

By contrast, critics have testified that (1) Rule 701 was solely intended for small startups and that by expanding the securities sales cap to $10 million, larger corporate issuers would be included under the rule, enabling them to deny their employee-investors corporate disclosures

generally available to other investors; (2) the bills could expand the number of employee-investors subject to the nondisclosure regime, potentially limiting their ability to understand the often-risky nature of such stocks, while at times being subject to employer pressure to purchase them; and (3) the legislation could result in more employees having concentrated amounts of employer-only stock, which flies in the face of conventional strategies of portfolio diversification to mitigate investment risk.