SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 230

[Release No. 33–7645; File No. S7–5–98]

RIN 3235–AH21

Rule 701—Exempt Offerings Pursuant to Compensatory Arrangements

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (''we'' or ''Commission'') is adopting amendments to Rule 701 under the Securities Act of 1933, which provides an exemption from registration for securities issued by non-reporting companies pursuant to compensatory arrangements. These amendments make Rule 701 more useful and eliminate unnecessary restrictions. We are removing the $5 million aggregate offering price ceiling and setting the maximum amount of securities that may be sold in a 12-month period to a more appropriate, flexible limit related to the size of the issuer. The amendments also require specific disclosure from issuers that sell more than $5 million worth of securities in a 12-month period, and harmonize the definition of consultant and advisor to the one contained in Form S–8, the short-form registration statement form for the offer and sale of employee benefit plan securities.

EFFECTIVE DATE: April 7, 1999.

FOR FURTHER INFORMATION CONTACT: Richard K. Wulff (202–942–2950), Office of Small Business, Division of Corporation Finance, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are adopting amendments to Rule 701 [1] under the Securities Act of 1933 (''Securities Act'').[2]

I. Executive Summary and Background

In 1988, we adopted Rule 701 under the Securities Act [3] to allow private companies to sell securities to their employees without the need to file a registration statement, as public companies do. The rule provides an exemption from the registration requirements of the Securities Act for offers and sales of securities under certain compensatory benefit plans or written agreements relating to compensation. The exemptive scope covers securities offered or sold under a plan or agreement between a non-reporting (''private'') company (or its parents or majority-owned subsidiaries) and the company's employees, officers, directors, partners, trustees, consultants and advisors.

When we adopted the rule, we determined that it would be an unreasonable burden to require these private companies, many of which are small businesses, to incur the expenses and disclosure obligations of public companies when their only public securities sales were to employees. Further, these sales are for compensatory and incentive purposes, rather than for capital-raising. To accommodate these companies, we used the maximum extent of the authority we had at that time under Section 3(b) of the Securities Act [4] to exempt offers and sales of up to $5 million per year.

Currently, the amount of securities subject to outstanding offers in reliance on Rule 701, plus the amount of securities offered or sold under the rule in the preceding 12 months, may not exceed the greatest of $500,000, or an amount determined under one of two different formulas. One formula limits the amount to 15% of the issuer's total assets measured at the end of the issuer's last fiscal year. The other formula restricts the amount to no more than 15% of the outstanding securities of the class being offered. Regardless of the formula elected, Rule 701 restricts the aggregate offering price of securities subject to outstanding offers and the amount sold in the preceding 12 months to no more than $5 million.

Over the years, our staff has monitored the use of the rule. The staff concluded that the rule has been popular for both small businesses and larger private companies. However, the $5 million limit appears to have become unnecessarily restrictive 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.

In October 1996, Congress enacted the National Securities Markets Improvement Act of 1996 (''NSMIA''),[5] which, for the first time, gave us the authority to provide exemptive relief in excess of $5 million for transactions such as these. The legislative history of NSMIA stated specifically that we should use this new authority to lift the $5 million ceiling on Rule 701.[6] In February 1998, we proposed a number of revisions to increase the flexibility and usefulness of Rule 701, as well as to simplify and clarify the rule.[7]

Today, we announce revisions to the rule that:

(1) remove the $5 million aggregate offering price ceiling and, instead, set the maximum amount of securities that may be sold in a year at the greatest of:
—$1 million (rather than the current $500,000);
—15% of the issuer's total assets; or
—15% of the outstanding securities of that class;

(2) require the issuer to provide specific disclosure to each purchaser of securities if more than $5 million worth of securities are to be sold;

(3) do not count offers for purposes of calculating the available exempted amounts; [8]

(4) harmonize the definition of consultants and advisors permitted to use the exemption to the narrower definition of Form S–8; [9]

(5) amend Rule 701 to codify current and more flexible interpretations; and

(6) simplify the rule by recasting it in plain English.

Together, these changes will add greater flexibility for companies to compensate sell securities their employees with securities and, at the same time, will provide that essential information be delivered to employees in appropriate situations and in a timely manner. The vast majority of commenters on the Rule 701 Proposing Release supported the proposed amendments, particularly the lifting of the $5 million aggregate offering price ceiling and the removing of offers from the ceiling calculation. A number of commenters, however, expressed concerns about the proposed disclosure requirements, particularly as they relate to foreign private issuers.

We have considered these comments and we believe that we have struck an

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[1] 17 CFR 230.701.

[2] 15 U.S.C. 77a *et seq.*

[3] Release No. 33–6768 (April 14, 1988) [53 FR 12918].

[4] 15 U.S.C. 77c(b).

[5] Pub. L. 104–290, 110 Stat. 3416 (October 11, 1996).

[6] Both Committee Reports specifically highlighted the current $5 million limit contained in Rule 701 and sought prompt Commission action to raise that ceiling to ''not less than $10 million.'' H.R. Rep. No. 104–622 at 38; S. Rep. No. 104–293 at 16.

[7] Release No. 33–7511 (February 27, 1998) [63 FR 10785] (''Rule 701 Proposing Release''). We received 33 letters of comment on the proposals. You may inspect and copy the comment letters in our Public Reference Room in File No. S7–5–98. Comments that were submitted electronically are available on our website (http://www.sec.gov).

[8] Note, however, that the rule now requires issuers to count as sales the securities underlying the options at the time of the option grant based upon the exercise price.

[9] 17 CFR 239.16b. Form S–8, a simplified form for registering sales to employees, is available only to public companies subject to the reporting requirements of the Securities Exchange Act of 1934 [15 U.S.C. 78a *et seq.*] (''Exchange Act''). See also the release relating to revisions to Form S–8 we are adopting today, Release No. 33–7646. (''S–8 Adopting Release'').

appropriate balance between the needs of employee-investors and the needs of non-reporting companies. In particular, we have decided to impose the disclosure requirements only on sales above $5 million, instead of on all Rule 701 sales, as proposed. These revisions to Rule 701 are being adopted pursuant to the exemptive authority provided to the Commission under Section 28 of the Securities Act.[10]

II. Amendments to Rule 701

The amendments to Rule 701 have been adopted in most respects as proposed, with the exceptions discussed below. The changes to the rule are not retroactive. Offers and sales made in reliance on Rule 701 before the effective date will continue to be valid if they met the conditions of the rule before its revision.[11] The principal changes are in the areas of exemptive limits, disclosure, and the treatment of consultants and advisors, as discussed in detail below. In addition, we are adopting a number of clarifying and simplifying provisions, including the following:

- Expanding the scope of the rule to exempt sales to employees of majority-owned subsidiaries of the issuer's parent (*i.e.*, brother-sister subsidiaries);
- Providing: (1) that 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 so long as the parent fully and unconditionally guarantees the obligations of the subsidiary issued under the rule (if the guarantee does not exceed 15% of the parent's assets), such as in the case of many deferred compensation arrangements; and (2) an exemption for the parent's guarantee;
- Clarifying that sales to former employees may be completed under the rule if those persons were employees when the securities initially were offered;[12]
- Specifying the manner of considering employee/consultant services in calculating the aggregate sales limit; and
- Facilitating tax and estate planning by permitting the rule to be available for option exercises by family members of employees who acquire Rule 701 securities from the employee through a gift or a domestic relations order.[13]

A. Exemptive Limits

As proposed, we are removing the $5 million aggregate offering price ceiling and raising the current $500,000 level that can be sold in a year to $1 million.[14] Also as proposed, the revised rule no longer limits the dollar amount of securities *offered* to employees. Instead, issuers will make calculations based solely on actual sales or amounts to be sold (as with options) in a 12-month period. Changing the focus from offers to sales will make it easier for issuers to determine the exempt amount of securities transactions, while continuing to assure that the transactions are not so large as to trigger the need for registration. We believe that these changes, in combination with the other changes adopted, will provide issuers the flexibility they need, without creating opportunities for abuse.

With respect to equity incentives such as restricted stock and compensatory stock purchases, the calculations will be made as of the transaction date. Deferred compensation and similar plans will make measurements based upon the date of an irrevocable election to defer compensation. With respect to options, calculations will be made as of the date of the option's grant, without regard to whether the option is currently exercisable or ''vested.'' We make this change for option calculations in response to comments emphasizing the difficulty in keeping track of outstanding options, when they become exercisable and when they might be exercised.[15] We believe that this method of determining the available exemption should make no difference from an investor protection point of view since the 12-month limit will still apply. However, this change will greatly simplify the issuer's oversight of outstanding offers and perhaps benefit more employees and others who may participate in the compensatory arrangements. The rule makes it clear that calculations with respect to options should be based on the exercise price, since the purpose is to measure the securities that will be sold under the exemption.[16]

Rule 701 provides that the calculation of the exempt amount should account for the value of both consultant and employee services.[17] A number of the commenters misunderstood this provision. The point of the revision is to clarify that compensatory arrangements should not be valued at ''zero'' or treated as a gift. Even when the employee or consultant is not required to pay additional consideration for the securities being issued, these securities typically would have some intrinsic worth, such as book value or a multiple of book value. The value of services exchanged for securities issued must be measured by reference to the value of the securities issued rather than the employee's salary or consultant's invoice. The rule as revised makes this clear.

B. Disclosure to Persons Covered by Rule 701

We were concerned that eliminating the $5 million ceiling could result in some very large offerings of securities without the protections of registration, even though made pursuant to compensatory arrangements. We therefore proposed to impose a specific disclosure requirement on all transactions under the exemption. We solicited comment on whether some dollar amount of transactions might not require specified disclosure, for example, $1 million. In response to comment, and our consideration of reasonable alternatives, we have decided to require no specified disclosure requirement for sales up to $5 million. This formulation apparently has worked well to date. We do not

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[10] ''The Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security or transaction, or any class or classes of persons, securities or transactions from any provision of this title or any rule or regulation issued under this title to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with protection of investors.'' 15 U.S.C. 77bb. As more fully described below, we find that the exemption is appropriate in the public interest and is consistent with the protection of investors.

[11] Offers that were being made under the Rule 701 exemption as it used to read may be consummated under those terms. For example, vested options may be exercised in reliance upon the prior version of Rule 701. Options issued in reliance upon the Rule 701 exemption (in contrast to a ''no sale'' theory) may be exercised in reliance upon the prior version of the rule, whether vested or unvested. See the interpretive letter to Richard M. Leisner (December 21, 1995).

[12] As adopted, the rule also includes former directors, officers, general partners, trustees, consultants and advisors.

[13] This change is consistent with the amendments to Form S–8 adopted today with respect to transferable securities. ''Family member'' is defined in Rule 701(c)(3) the same way as ''family member'' in General Instruction A.1(a)(5) of Form S–8 as adopted today in the S–8 Adopting Release.

[14] The revised rule also makes it clear, as proposed, that the calculations of total assets and securities outstanding are measured as of the issuer's most recent balance sheet date, which must be no older than the end of its last fiscal year.

[15] In particular, commenters were concerned that basing calculations on the option exercise date could result in an unanticipated loss of the exemption if too many optionees exercised their options at the same time. Although options are offers of the underlying securities that can be made without limitation and are exempt under the revised rule, using the exercise price at the date of grant simplifies the calculations of the available exemption amount and allows issuers to avoid the administrative difficulties of keeping track of outstanding options.

[16] In the event that exercise prices are later changed or repriced, a recalculation will have to be made under Rule 701.

[17] Rule 701(d)(3)(i).

believe the exemption has been misused for fraudulent purposes in its current format. We agree with the commenters that the additional burdens related to mandatory financial and risk disclosure for these limited offerings are unnecessary.

On the other hand, the revised rule provides no aggregate offering price ceiling and thus substantial amounts of securities exceeding $5 million may be issued by large private companies. Indeed, a number of commenters with this profile urged the Commission to remove the ceiling quickly so that they can enjoy sooner the benefits of the exemption for their compensatory arrangements. These commenters appear to be comfortable with a greater disclosure requirement as the tradeoff for greater use of the exemptive rule. Moreover, we believe that many of these companies already have prepared the type of disclosure required in their normal course of business, either for using other exemptions, such as Regulation D [18] or for other purposes. As a result, the disclosure requirement generally would be less burdensome for them. If these companies do not want to disclose the requisite information to their employees and others, they may continue to follow the current provisions of the rule and keep the amount sold below $5 million in a 12-month period. In that case, they would continue to provide only the disclosure needed to satisfy the antifraud provisions of the law.[19]

We would have investor protection concerns if we removed the $5 million ceiling without imposing specific disclosure requirements, as discussed below. In contrast, we believe that disclosure requirements are not needed for offerings below the $5 million threshold at this time. We have not witnessed abuse below this threshold, and therefore the burden of preparing and disseminating the new disclosure does not justify the potential benefits to employee-investors.

Where the formula permits sales in excess of $5 million during a 12-month period, and the issuer chooses to take advantage of this increased amount, the new disclosure should be provided to all investors before sale. This requirement will obligate issuers to provide disclosure to all investors if the issuer believes that sales will exceed the $5 million threshold in the coming 12-month period. If disclosure has not been provided to all investors before sale, the issuer will lose the exemption for the entire offering when sales exceed the $5 million threshold.

The disclosure requirements are adopted as proposed. The required disclosure consists of:

- A copy of the compensatory benefit plan or contract;[20]
- A copy of the summary plan description required by the Employee Retirement Income Security Act of 1974 (''ERISA'') [21] or, if the plan is not subject to ERISA, a summary of the plan's material terms;
- Risk factors associated with investment in the securities under the plan or agreement; and
- The financial statements required in an offering statement on Form 1–A [22] under Regulation A.[23]

The type and amount of disclosure needed in a compensatory securities transaction differs from that needed in a capital-raising transaction. In a bona fide compensatory arrangement, the issuer is concerned primarily with compensating the employee-investor rather than maximizing its proceeds from the sale. Because the compensated individual has some business relationship, perhaps extending over a long period of time, with the securities issuer, that person will have acquired some, and in many cases, a substantial amount of knowledge about the enterprise. The amount and type of disclosure required for this person is not the same as for the typical investor with no particular connection with the issuer. The current standards of financial statement disclosure contained in Regulation A should satisfy our concerns for a level of disclosure that will provide basic protections in a compensatory transaction but may not be available as a result of ordinary employment or business dealings.[24] The standard is well established and may be very familiar to private issuers, since these financial statements and risk factor disclosure requirements are used not only in Regulation A, but also in the private placement exemptions contained in Regulation D.[25]

Compliance with the minimum disclosure standards for Rule 701 may not necessarily meet the antifraud standards of the securities law.[26] The disclosure required will depend upon the facts circumstances.[27]

Some commenters expressed concern that requiring a private issuer to deliver disclosure documents, particularly financial statements, to employee-investors could result in serious harm to the company if the information were to come into possession of its competitors. In view of the substantial amounts of securities that may now be issued under Rule 701, we believe that a minimal level of disclosure consisting of risk factors and Regulation A unaudited financial statements is essential to meet even the lower level of information needed to inform compensatory-type investors such as employees and consultants. Private issuers can use certain mechanisms, such as confidentiality agreements, to protect competitive information. Alternatively, an issuer could elect to stay below the $5 million threshold to avoid these disclosure obligations.

C. Foreign Private Issuers

In the Rule 701 Proposing Release, we especially sought comment on how foreign private issuers [28] should be treated under Rule 701, given that more and more U.S. persons are employed by foreign companies. Many foreign private issuers with substantial amounts of securities held by U.S. persons provide only ''home country reports'' and do not prepare financial statements with a reconciliation to U.S. generally accepted accounting principles (''GAAP'') because of the Rule 12g3–2(b) exemption from the registration requirements of the Exchange Act.[29] This exemption is available even though

[18] 17 CFR 230.501 *et seq.*

[19] See Preliminary Note 1 to Rule 701.

[20] A copy of the compensatory benefit plan or contract must be given to all offerees under current Rule 701. Under the revisions, this will continue to be required, whether or not the specific disclosure requirement is triggered by exceeding the $5 million amount.

[21] 29 U.S.C. 1104–1107.

[22] 17 CFR 239.90. Part F/S of Form 1–A generally provides for unaudited financial statements. However, issuers that have audited financial statements must provide them, instead of unaudited ones.

[23] 17 CFR 230.251 *et seq.*

[24] As proposed and adopted, if a reporting company is relying on Rule 701 to guarantee the obligations of a subsidiary's securities sold under the rule, the issuer must deliver the parent's financial statements that would be required by Rule 10–01 of Regulation S–X (17 CFR 210.10–01) and Item 310 of Regulation S–B (17 CFR 228.310). Rule 701(e)(5).

[25] See Rule 502(b)(2)(i)(A) of Regulation D [17 CFR 230.502(b)(2)(i)(A)].

[26] *E.g.,* Section 17(a) of the Securities Act [15 U.S.C. 77q(a)], Section 10(b) of the Exchange Act [15 U.S.C. 78j(b)], and Rule 10b–5 [17 CFR 240.10b–5].

[27] Issuers eligible to take advantage of the increased availability of the exemption also should be mindful of the requirements of the Exchange Act [15 U.S.C. 78*l*(g)]. Once an issuer exceeds 500 shareholders and $10 million in assets, it must register under Section 12(g) of the Exchange Act and provide full disclosure as a ''public'' company. See Rule 12g–1 [17 CFR 240.12g–1].

[28] This term is defined in Rule 405 [17 CFR 230.405].

[29] 17 CFR 240.12g3–2(b). Rule 12g3–2(b) exempts from Exchange Act registration securities of a foreign private issuer, if the issuer furnishes to us annual and other reports and other materials that are publicly available in its home market.

the number of U.S. holders may exceed 500 and total company assets exceed $10 million, which ordinarily would trigger the Exchange Act reporting requirements.

We solicited comment on whether non-reporting foreign private issuers should be subject to some annual ceiling, such as $10 million. Without a limit, the new calculation formula could result in the sale of a large amounts of securities to a many employees without such companies ever being required to register under the Securities Act or the Exchange Act. Commenters objected to a limit, noting that foreign private issuers typically undertake broad-based offerings to their U.S. employees for legitimate compensatory reasons and in order to treat all of their employees alike regardless of their location. Many commenters expressed the view that any tightening of the exemption for foreign private issuers would simply result in securities-based incentives not being offered to the U.S. employees of foreign issuers.

We have determined not to impose any annual ceiling on foreign private issuers, given the compensatory nature of Rule 701 offerings and the detrimental effect that such a rule could have on the compensation packages of U.S. employees. Instead, non-reporting foreign private issuers will be required to provide the same disclosure as non-reporting domestic issuers if sales under Rule 701 exceed $5 million in a 12-month period.[30] Imposing this obligation on all issuers is the price for removal of the $5 million offering limit.

We do not believe that any additional modification needs to be made at this time for foreign private issuers because they will be subject to the same disclosure requirements as domestic issuers. When, and if, we accept international accounting standards or guidelines for filing and reporting purposes, we would amend Rule 701 to allow these standards to satisfy the rule's financial statement disclosure obligations for foreign private issuers. For issuers making smaller offerings, the foreign companies may continue to follow the rule as they have in the past, which means that ''home country'' reports may be used, as necessary, to satisfy the antifraud standards. However, larger companies that cross the $5 million barrier will have to provide the disclosure required under Regulation A, which includes unaudited financial statements.

Where financial statements prepared in accordance with U.S. GAAP are not provided, a reconciliation to such principles must be attached.[31] The provisions of Regulation A suggest that a reconciliation is permitted only for Canadian companies. This is because Canadian companies are the only foreign issuers eligible to use that exemption. In contrast, any foreign issuer is eligible to use Rule 701, but if it exceeds the $5 million amount it must provide financial statements as required by Regulation A. If U.S. GAAP financials are not available, the financials provided must be reconciled to U.S. GAAP. Although there are costs involved in preparing the reconciliation and a number of the commenters objected to the notion of preparing a reconciliation to U.S. GAAP, we believe that the minimal level of disclosure for these compensatory transactions is the Regulation A financial statements, which must be reconciled to U.S. GAAP. Foreign private issuers that do not wish to provide the disclosure specified may elect to keep their Rule 701 sales below the $5 million threshold for disclosure, the same as for domestic issuers.

D. Consultants and Advisors

Like regular employees, consultants and advisors are eligible to receive securities under the Rule 701 exemption. Similarly, where the issuer is a reporting company, consultants and advisors may receive securities in a transaction registered on Form S–8.[32] Currently, the staff interprets the scope of eligible consultants and advisors differently for purposes of Rule 701 and Form S–8. The staff has interpreted Rule 701 to permit participation by a broader range of consultants and advisors, even though the words are identical in both Rule 701 and Form S–8.

At the same time we proposed changes to Rule 701, we proposed changes to Form S–8 to further limit further the scope of eligible consultants and advisors.[33] In many cases, the Form has been misused by registering shares for issuance to consultants and advisors who do not have sufficient connection and familiarity with, the company. In some cases, these persons are receiving the securities for capital-raising, rather than compensatory, purposes and engage in public distributions of the company's securities.[34]

In the Rule 701 Proposing Release, we asked how consultants and advisers participate in compensatory arrangements and whether we should restrict their participation. We also asked whether Rule 701 and Form S–8 should be harmonized in their treatment of these persons. We are concerned that persons who would misuse exemptions will develop new methods to abuse deregulatory safe harbors, even as we are taking steps to close down other avenues for abuse.

We have determined that the flexible definition of ''consultants and advisors,'' particularly in the context of registered offerings on Form S–8, has led to abuse. We are concerned that Rule 701 could be similarly abused if we make changes only to Form S–8, even though Rule 701 securities, unlike Form S–8 securities, are restricted.[35] We are therefore adopting a definition of the term ''consultants and advisors'' in Rule 701 that will harmonize with the new definition in Form S–8,[36] and narrow the scope of eligible consultants and advisors.

As revised, securities promoters clearly will be excluded from the scope of persons eligible to participate under the exemption. Independent agents,[37] franchisees and salespersons who do not have an employment relationship with the issuer no longer will be within the scope of ''consultant or advisor.'' [38] A person in a *de facto* employment relationship with the issuer, such as a non-employee providing services that traditionally are performed by an

[30] See Section II.B above.

[31] See Item 17 of Form 20–F [17 CFR 249.220f].

[32] General Instruction A.1(a) to Form S–8.

[33] See Release No. 33–7506 (Feb. 17, 1998) [63 FR 9648] (''S–8 Proposing Release'').

[34] For a fuller discussion of misuse of Form S–8 involving consultant and advisors, see the S–8 Proposing Release and the S–8 Adopting Release. Today we also propose additional amendments to Form S–8, which are designed to address abuses in the use of that form.

[35] Ninety days after a company becomes subject to the reporting requirements of the Exchange Act, the restrictions lapse. Rule 701(g)(3). Under the revised rule, because all offers are exempt, and for purposes of ceiling calculations option exercise prices are used at the date of grant regardless of the current exercisability of the option, vested or unvested options will be exercisable in reliance upon Rule 701 even after the issuer becomes a public company. *Cf.* the interpretive letter to Richard M. Leisner (December 21, 1995).

[36] The S–8 Adopting Release adopts the ccorresponding changes into Form S–8. That release also provides additional guidance on determining the scope of eligible consultants and advisors. See S–8 Adopting Release Section II.A.2. This guidance is applicable to Rule 701 as well as to Form S–8.

[37] In the revisions to Form S–8 adopted today, we permit insurance agents who are exclusive agents of the issuer, its subsidiaries or parents or who derive more than 50% of their annual income from the issuer to be considered ''employees'' under Form S–8. We have made a corresponding change to Rule 701.

[38] The following interpretive letters defining eligible consultants or advisors under Rule 701 may no longer be relied upon, as of the effective date of the amendments, except to the extent that they have been relied upon for currently outstanding offers and previous sales under the provision: Golfpro, Inc. (October 3, 1989); Herff Jones, Inc. (November 13, 1990); Microchip Technology, Inc. (November 4, 1992); Optika Imaging Systems, Inc. (October 1, 1996); USWeb Corporation (November 7, 1996).

employee,[39] with compensation paid for those services being the primary source of the person's earned income, would qualify as an eligible person under the exemption.[40] Other persons displaying significant characteristics of ''employment,'' such as the professional advisor providing bookkeeping services, computer programming advice, or other valuable professional services may qualify as eligible consultants or advisors, depending upon the particular facts and circumstances.[41] Our staff will continue to handle questions about ''consultant or advisor'' status on a case-by-case basis through its interpretive letter process, but the terms will be interpreted in the same manner for both Rule 701 and Form S–8.

E. Other Revisions

Because it has become increasingly commonplace to sell stock of a private subsidiary to employees of a parent or affiliate subsidiary, and because these transactions retain the envisioned compensatory character, we have implemented our proposal to expand exemption coverage to sales to employees of majority-owned subsidiaries of the issuer's parent (*i.e.*, brother-sister subsidiaries).[42]

We also have adopted our proposal that Rule 701 should be available for sales, such as option exercises, by family donees of compensatory securities and transferees who receive these securities in divorce proceedings. Rule 701 is now available for immediate family members who have acquired such securities through a gift or a domestic relations order. For this purpose ''family member'' is defined as in Form S–8 to include 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 or 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 have more than a fifty percent beneficial interest, a foundation 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. This provision is consistent with the treatment of transferable securities under Form S–8.[43]

III. Cost-Benefit Analysis

As an aid in the evaluation of the costs and benefits of our original proposals, which were deregulatory in nature, we requested the views and other supporting information of the public. We received no comments in response to this request. Nonetheless, we believe that the rule as revised provides substantial benefits that justify any costs involved. A major feature of the exemption is its regulatory flexibility. Thus, benefits it offers include maintaining the existing exemption for small companies, expanding the availability of the exemption by applying otherwise established disclosure requirements, and permitting companies to preserve cash by using stock for compensatory purposes. The amended rule as a whole provides regulatory relief for companies, even larger ones, although relief with the fewest conditions continues to be for small issuers and others that decide to maintain their offerings below the $5 million ceiling.

For every issuer, the minimum available exemptive amount has been increased from $500,000 to $1 million. This doubling of exemption should be particularly attractive to smaller companies that are unable to utilize the formulas effectively. In addition, we have decided not to require specified disclosure requirements, including financial statements, for sales up to $5 million. Further, we determined not to reinstitute a filing requirement such as Form 701 to report when the exemption is used.

On the other hand, the revised rule provides no aggregate offering price ceiling and thus substantial amounts of securities exceeding $5 million may be issued by large private companies. If these companies do not want to disclose the requisite information to their employees and others, they may continue to follow the current provisions of the rule and keep the amount sold below $5 million in a 12-month period. In that case, they would not have to provide the specified disclosure.

The ability to reward and retain employees with a company's securities will permit companies to keep valuable employees without having to use other methods to compensate them, such as borrowing money or selling securities. Because the rule may encourage companies to offer incentives to their employees and others, for example through deferred compensation arrangements, and also facilitates interfamily donative transfers, it may provide benefits from the perspective of tax and estate planning as well.

We have concluded that the rule amendments will not result in a major increase in costs or prices for consumers or individual industries, or significant adverse effects on competition, employment, investment, productivity, innovation or small business. We believe that persons who will rely on the rule will not have significantly increased costs. In fact, since the current version of the rule is essentially retained for offerings under the former $5 million ceiling, there should be no change in the costs of compliance for issuers that have historically used the exemption and continue to keep their offerings under $5 million. For issuers that are large enough to go above the $5 million threshold and therefore are required to provide specified disclosure, any additional costs may not be significant. Some of the commenters fitting this profile stated that they either already provide or have the required information readily available for their employees and other persons.

Some issuers, however, will face costs in availing themselves of the increased benefits of the rule—primarily those who decide to issue more than $5 million worth of securities in the 12-month period. It is worth noting, however, that these increased costs would be borne voluntarily. Issuers can perform their own cost-benefit analysis to decide whether to do an offering in excess of $5 million under the rule. Currently, issuers do not have the option to make an offering exceeding $5 million under Rule 701. Even in these cases, the costs of using Rule 701 may be lower than the costs of using another exemption or registering the sales. Such costs may include ''in-house'' preparation of disclosure documents, hiring of attorneys and accountants, and delivery and printing costs.

[39] However, these services must not be in connection with the offer or sale of securities in a capital-raising transaction, and must not directly or indirectly promote or maintain a market for the issuer's securities.

[40] See Foundation Health Corporation (July 12, 1993).

[41] Morgan Health Group, Inc. (December 18, 1995); Princeton Medical Managers Resources (September 12, 1997); PHM Management Resources, Inc. (September 16, 1997); Talbert Medical Corporation (September 16, 1997); Osler Health, Inc. (February 11, 1998); Comprehensive Health Care Corp. (April 30, 1998) are inconsistent with the interpretation rendered in the *Foundation Health* letter under Form S–8 and are also overturned today, although they too may continue to be relied upon for outstanding offers and previous sales. These issuers may resubmit their interpretive requests for staff consideration, highlighting in their submissions the type of arrangements between the parties that show the services, if any, that the physicians provide to the issuers and others to permit an assessment of their status under the new ''consultant and advisor'' provision.

[42] Rule 701(c). Form S–8 continues to be unavailable for offers and sales to employees of brother-sister subsidiaries.

[43] See the S–8 Adopting Release.

Nonetheless, because there may be more securities sales to more investors, we believe that mandatory disclosure is necessary for investor protection.

The change to the ''consultants and advisors'' definition, which is necessary to counteract abuses we have found with some ''compensatory'' arrangements, will impact use of the Rule 701 exemption and perhaps disadvantage some issuers in their ability to effectively use the provision. However, the staff will continue to consider interpretive requests of the term, including reconsideration of some of the letters we are overturning today.

IV. Exemptive Authority Findings

We find that exempting transactions by nonreporting companies pursuant to compensatory benefit plans and written compensatory contracts from Section 5 of the Securities Act is appropriate in the public interest and is consistent with the protection of investors. We make these findings based on the reasons that we describe in this release. In particular, we have determined that Rule 701 has successfully allowed small businesses to compensate their employees with securities. The amendments will permit smaller businesses to issue up to $1 million in securities to their employees, an increase from the current $500,000 limit, without regard to the company's size. The amendments also will permit larger private companies to issue more than $5 million, subject to the established financial statement requirements of Regulation A and provision of risk factor disclosure. Our use of exemptive authority will allow more companies and more investors to benefit from this rule.

The rule is specifically designed not to raise capital. The ability to reward and retain employees with a company's securities should aid companies by providing a mechanism to keep valuable employees without having to use other methods to compensate them, such as borrowing money or selling securities. Finally, Rule 701 provides private companies with some of the benefits public companies have under Form S–8.

Furthermore, we have not found instances of abuse of Rule 701, nor have we become aware of investor complaints. Rather, investors have enjoyed the benefits of being compensated with the securities of the company for which they are employed or provide services. Therefore, we have found that Rule 701 has been consistent with investor protection in the past. We realize, however, that the exemption will lead to a greater volume of sales to a larger number of investors. We believe that requiring disclosure for these larger offerings will help assure that the use of our exemptive authority in this context is consistent with the protection of investors.

V. Summary of Final Regulatory Flexibility Analysis

In accordance with 5 U.S.C. 604, we have prepared a Final Regulatory Flexibility Analysis (''FRFA'') regarding the proposed amendments.

The analysis notes that the amendments to Rule 701 are a result of: (1) concerns expressed to us by practitioners; (2) feedback that the current dollar limitations unduly constrain the ability of many eligible issuers to use Rule 701; and (3) the specific Congressional mandate expressed in the legislative history of NSMIA. The purpose of the revisions is to remove unnecessary constraints. We have determined that the amendments will not impair investor protection.

As the FRFA describes, from mid-1988 through mid-1993, 1,069 companies filed 1,294 Forms 701 indicating aggregate sales of about $2.28 billion. On an annual basis, an average of 214 companies reported $456 million of sales on approximately 260 Forms 701. Based on an analysis of a sample of these filings, the Commission's Office of Economic Analysis estimates that 14% of the filings were made by small businesses. More current information is not available because Form 701 has not been a required submission since 1993.

The revisions should permit greater use of the exemption by small and large non-reporting issuers alike. The minimum amount that any issuer can raise under the exemption has been raised from $500,000 to $1 million. Greater availability of the exemption for employee benefit, deferred compensation and other plans, as well as to facilitate family donative transfers, should aid in tax and estate planning. We expect, therefore, that more companies will use the rule and that the value of securities sold under the exemption will be larger than it was in the 1988–1993 period. Accordingly, for purposes of estimating the amendments' economic impact, we estimate that 300 companies per year will make sales pursuant to Rule 701 and that 42 (14%) of those companies will be small businesses.

The amendments do not impose any new recordkeeping requirements or require reporting of additional information. Nonetheless, there is an impact, especially for larger private companies that choose to offer compensatory arrangements in excess of the current $5 million ceiling, as those companies will need to prepare specified disclosure and provide it to their participating employees. Because a number of commenters told us that this information is commonly maintained by this class of issuer (generally not small entities) in order to satisfy requirements for securities issuance exemptions (such as for private placements), loans and other purposes such as regulatory and internal ones, the amendments will not increase reporting, recordkeeping or compliance burdens, and may reduce those burdens for some companies.

As discussed more fully in the FRFA, several possible significant alternatives to the amendments were considered to minimize effects on small entities. These included establishing different compliance or reporting requirements for small entities, exempting them from all or part of the proposed requirements, or requiring them to provide different disclosure, such as all Form 1-A items or the full disclosure requirements of Form SB–1 or SB–2. In fact, the rule as adopted is changed from our initial proposal, which would have required all entities to provide certain disclosure. As adopted, only issuers selling more than $5 million during a 12-month period will be required to provide disclosure. The FRFA also indicates that no current federal rules duplicate, overlap, or conflict with the proposed rule amendments.

We encouraged written comments on any aspect of the Initial Regulatory Flexibility Analysis, but received no specific comments in response to our request. In particular, we sought comment on: (1) the number of small entities that would be affected by the proposed rule amendments; and (3) the determination that the proposed rule amendments would not increase (and in some cases may reduce) reporting, recordkeeping and other compliance requirements for small entities. For purposes of making determinations required by the Small Business Regulatory Enforcement Fairness Act of 1996 (''SBREFA''),[44] we also requested data regarding the potential impact of the proposed amendments on the economy on an annual basis. We received no comments in response to this request either. A copy of the Final Regulatory Flexibility Act Analysis may be obtained from Twanna M. Young, Office of Small Business, Division of Corporation Finance, Securities and

[44] Pub. L. No. 104–121, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C., and as a note to 5 U.S.C. 601).

Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

VI. Paperwork Reduction Act

Our staff consulted with the Office of Management and Budget (''OMB'') and submitted the proposals for review in accordance with the Paperwork Reduction Act of 1995 (''the Act'').[45] The title to the affected information collection is: ''Rule 701.'' The specific information that must be included is explained in the rule itself, and relates to the issuer and other information that may be associated with investment in securities under the plan or agreement. The information is needed by prospective purchasers to make informed investment decisions.

The proposed amendments will increase the flexibility and utility of Rule 701 for private companies using securities to compensate their employees.

The collection of information in Rule 701 will be required in order for companies to use the rule for sales of their securities to their employees and other persons covered by the rule. The likely respondents to the rule are companies that previously used the rule, but were being constrained by its limits, and companies thatwho could not use the rule at all because of its limits. While we cannot predict the number of respondents that may use expanded Rule 701, there were 1,294 Form 701 filings during the period from mid-1988 through mid-1993, when persons relying upon the exemption were required to file reports with us concerning their use of the exemption. On the basis of these historical filings under Rule 701, we estimate that approximately 300 companies each year will rely on the exemption. The estimated burden for responding to the collection of information in Rule 701 will not increase for most companies due to the current disclosure requirements in Rule 701, but may increase slightly for other companies who may not be currently providing risk factors and Regulation A financial statements to employee-purchasers. We estimate that the burden hours per respondent each year will be two. Therefore, we estimate an aggregate of 600 burden hours per year.

The information collection requirements imposed by Rule 701 are mandatory to the extent that a company elects to use the Rule 701 exemption. The information will be disclosed to third parties or the public. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a current valid OMB control number.

We received no comments in response to our request for comment regarding the information collection obligation.

VII. Statutory Basis, Text of Amendments and Authority

The amendments to our rules and forms are being adopted pursuant to sections 2, 3(b), 6, 7, 8, 10, 19(a) and 28 of the Securities Act.

List of Subjects in 17 CFR Part 230

Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulations is amended as follows:

PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The authority citation for part 230 continues to read as follows:

Authority: 15 U.S.C. 77b, 77f, 77g, 77h, 77j, 77r, 77s, 77sss, 78c, 78d, 78l, 78m, 78n, 78o, 78w, 78*ll*(d), 79t, 80a–8, 80a-24, 80a–28, 80a–29, 80a–30, and 80a–37, unless otherwise noted.

2. By revising § 230.701 to read as follows:

§ 230.701 Exemption for offers and sales of securities pursuant to certain compensatory benefit plans and contracts relating to compensation.

Preliminary Notes

1. This section relates to transactions exempted from the registration requirements of section 5 of the Act (15 U.S.C. 77e). These transactions are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws. Issuers and persons acting on their behalf have an obligation to provide investors with disclosure adequate to satisfy the antifraud provisions of the federal securities laws.

2. In addition to complying with this section, the issuer also must comply with any applicable state law relating to the offer and sale of securities.

3. An issuer that attempts to comply with this section, but fails to do so, may claim any other exemption that is available.

4. This section is available only to the issuer of the securities. Affiliates of the issuer may not use this section to offer or sell securities. This section also does not cover resales of securities by any person. This section provides an exemption only for the transactions in which the securities are offered or sold by the issuer, not for the securities themselves.

5. The purpose of this section is to provide an exemption from the registration requirements of the Act for securities issued in compensatory circumstances. This section is not available for plans or schemes to circumvent this purpose, such as to raise capital. This section also is not available to exempt any transaction that is in technical compliance with this section but is part of a plan or scheme to evade the registration provisions of the Act. In any of these cases, registration under the Act is required unless another exemption is available.

(a) *Exemption.* Offers and sales made in compliance with all of the conditions of this section are exempt from section 5 of the Act (15 U.S.C. 77e).

(b) *Issuers eligible to use this section.* (1) *General.* This section is available to any issuer that is not subject to the reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934 (the ''Exchange Act'') (15 U.S.C. 78m or 78o(d)) and is not an investment company registered or required to be registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*).

(2) *Issuers that become subject to reporting.* If an issuer becomes subject to the reporting requirements of section 13 or 15(d) of the Exchange Act (15 U.S.C. 78m or 78o(d)) after it has made offers complying with this section, the issuer may nevertheless rely on this section to sell the securities previously offered to the persons to whom those offers were made.

(3) *Guarantees by reporting companies.* An issuer subject to the reporting requirements of section 13 or 15(d) of the Exchange Act (15 U.S.C. 78m, 78o(d)) may rely on this section if it is merely guaranteeing the payment of a subsidiary's securities that are sold under this section.

(c) *Transactions exempted by this section.* This section exempts offers and sales of securities (including plan interests and guarantees pursuant to paragraph (d)(2)(ii) of this section) under a written compensatory benefit plan (or written compensation contract) established by the issuer, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of the issuer's parent, for the participation of their employees, directors, general partners, trustees (where the issuer is a business trust), officers, or consultants and advisors, and their family members who acquire such securities from such persons through gifts or domestic relations orders. This section exempts offers and sales to former employees, directors, general partners, trustees, officers, consultants and advisors only if such persons were employed by or providing services to the issuer at the time the securities were offered. In addition, the term ''employee'' includes insurance agents who are exclusive agents of the issuer, its subsidiaries or

[45] 44 U.S.C. 3501 *et seq.*

parents, are or derive more than 50% of their annual income from those entities.

(1) *Special requirements for consultants and advisors.* This section is available to consultants and advisors only if:

(i) They are natural persons;

(ii) They provide *bona fide* services to the issuer, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of the issuer's parent; and

(iii) The services are not in connection with the offer or sale of securities in a capital-raising transaction, and do not directly or indirectly promote or maintain a market for the issuer's securities.

(2) *Definition of ''Compensatory Benefit Plan.''* For purposes of this section, a *compensatory benefit plan* is any purchase, savings, option, bonus, stock appreciation, profit sharing, thrift, incentive, deferred compensation, pension or similar plan.

(3) *Definition of ''Family Member.''* For purposes of this section, *family member* includes 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, or 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 have more than fifty percent of the beneficial interest, a foundation 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.

(d) *Amounts that may be sold.* (1) *Offers.* Any amount of securities may be offered in reliance on this section. However, for purposes of this section, sales of securities underlying options must be counted as sales on the date of the option grant.

(2) *Sales.* The aggregate sales price or amount of securities sold in reliance on this section during any consecutive 12-month period must not exceed the greatest of the following:

(i) $1,000,000;

(ii) 15% of the total assets of the issuer (or of the issuer's parent if the issuer is a wholly-owned subsidiary and the securities represent obligations that the parent fully and unconditionally guarantees), measured at the issuer's most recent annual balance sheet date (if no older than its last fiscal year end); or

(iii) 15% of the outstanding amount of the class of securities being offered and sold in reliance on this section, measured at the issuer's most recent annual balance sheet date (if no older than its last fiscal year end).

(3) *Rules for calculating prices and amounts.* (i) *Aggregate sales price.* The term *aggregate sales price* means the sum of all cash, property, notes, cancellation of debt or other consideration received or to be received by the issuer for the sale of the securities. Non-cash consideration must be valued by reference to *bona fide* sales of that consideration made within a reasonable time or, in the absence of such sales, on the fair value as determined by an accepted standard. The value of services exchanged for securities issued must be measured by reference to the value of the securities issued. Options must be valued based on the exercise price of the option.

(ii) *Time of the calculation.* With respect to options to purchase securities, the aggregate sales price is determined when an option grant is made (without regard to when the option becomes exercisable). With respect to other securities, the calculation is made on the date of sale. With respect to deferred compensation or similar plans, the calculation is made when the irrevocable election to defer is made.

(iii) *Derivative securities.* In calculating outstanding securities for purposes of paragraph (d)(2)(iii) of this section, treat the securities underlying all currently exercisable or convertible options, warrants, rights or other securities, other than those issued under this exemption, as outstanding. In calculating the amount of securities sold for other purposes of paragraph (d)(2) of this section, count the amount of securities that would be acquired upon exercise or conversion in connection with sales of options, warrants, rights or other exercisable or convertible securities, including those to be issued under this exemption.

(iv) *Other exemptions.* Amounts of securities sold in reliance on this section do not affect ''aggregate offering prices'' in other exemptions, and amounts of securities sold in reliance on other exemptions do not affect the amount that may be sold in reliance on this section.

(e) *Disclosure that must be provided.* The issuer must deliver to investors a copy of the compensatory benefit plan or the contract, as applicable. In addition, if the aggregate sales price or amount of securities sold during any consecutive 12-month period exceeds $5 million, the issuer must deliver the following disclosure to investors a reasonable period of time before the date of sale:

(1) If the plan is subject to the Employee Retirement Income Security Act of 1974 (''ERISA'') (29 U.S.C. 1104–1107), a copy of the summary plan description required by ERISA;

(2) If the plan is not subject to ERISA, a summary of the material terms of the plan;

(3) Information about the risks associated with investment in the securities sold pursuant to the compensatory benefit plan or compensation contract; and

(4) Financial statements required to be furnished by Part F/S of Form 1–A (Regulation A Offering Statement) (§ 239.90 of this chapter) under Regulation A (§§ 230.251 through 230.263). Foreign private issuers as defined in § 230.405 must provide a reconciliation to generally accepted accounting principles in the United States (U.S. GAAP) if their financial statements are not prepared in accordance with U.S. GAAP (Item 17 of Form 20–F (§ 249.220f of this chapter)). The financial statements required by this section must be as of a date no more than 180 days before the sale of securities in reliance on this exemption.

(5) If the issuer is relying on paragraph (d)(2)(ii) of this section to use its parent's total assets to determine the amount of securities that may be sold, the parent's financial statements must be delivered. If the parent is subject to the reporting requirements of section 13 or 15(d) of the Exchange Act (15 U.S.C. 78m or 78o(d)), the financial statements of the parent required by Rule 10–01 of Regulation S–X (§ 210.10–01 of this chapter) and Item 310 of Regulation S–B (§ 228.310 of this chapter), as applicable, must be delivered.

(6) If the sale involves a stock option or other derivative security, the issuer must deliver disclosure a reasonable period of time before the date of exercise or conversion. For deferred compensation or similar plans, the issuer must deliver disclosure to investors a reasonable period of time before the date the irrevocable election to defer is made.

(f) *No integration with other offerings.* Offers and sales exempt under this section are deemed to be a part of a single, discrete offering and are not subject to integration with any other offers or sales, whether registered under the Act or otherwise exempt from the registration requirements of the Act.

(g) *Resale limitations.* (1) Securities issued under this section are deemed to be ''restricted securities'' as defined in § 230.144.

(2) Resales of securities issued pursuant to this section must be in compliance with the registration

requirements of the Act or an exemption from those requirements.

(3) Ninety days after the issuer becomes subject to the reporting requirements of section 13 or 15(d) of the Exchange Act (15 U.S.C. 78m or 78o(d)), securities issued under this section may be resold by persons who are not affiliates (as defined in § 230.144) in reliance on § 230.144, without compliance with paragraphs (c), (d), (e) and (h) of § 230.144, and by affiliates without compliance with paragraph (d) of § 230.144.

Dated: February 25, 1999.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 99–5296 Filed 3–5–99; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 228, 229, 230 and 239

[Release No. 33–7646, 34–41109; File No. S7–2–98]

RIN 3235–AG94

Registration of Securities on Form S–8

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (''we'' or ''Commission'') is adopting amendments to Form S–8, related rules under the Securities Act, and Regulations S–K and S–B. Some of the amendments restrict the use of Form S–8 for the offer and sale of securities to consultants and advisors. Other amendments allow the use of Form S–8 for the exercise of stock options by family members of employee optionees.

DATES: *Effective Date:* The amendments are effective April 7, 1999. *Compliance Date:* Currently effective registration statements on Form S–8 need not comply with amended § 230.405 and amended General Instruction A.1.(a)(1) to Form S–8 (referenced in § 239.16b) until May 10, 1999.

FOR FURTHER INFORMATION CONTACT: Anne M. Krauskopf, Special Counsel, Office of Chief Counsel, Division of Corporation Finance, at (202) 942–2900.

SUPPLEMENTARY INFORMATION: We are adopting amendments to Rules 401 [1] and 405 [2] under the Securities Act of 1933 (''Securities Act''),[3] Item 402 [4] of Regulations S–B and S–K, and Securities Act Forms S–3 [5] and S–8.[6]

I. Executive Summary

Today we adopt rule amendments that address two separate concerns involving the use of Form S–8 to register the offer and sale of employee benefit plan securities.

- First, we adopt amendments designed to restrict the availability of streamlined registration on Form S–8 in order to deter abuse of the form. In particular, the form has been misused to sell securities to the general public through employees and nominal ''consultants and advisors,'' and to register securities issued to stock promoters. We are adopting these amendments as part of our comprehensive agenda to deter registration and trading abuses, including microcap fraud.[7]
- Second, we are expanding Form S–8 to cover stock option exercises by employees' family members, so that the rules governing use of the form do not impede legitimate intra-family transfers of options by employees. These amendments will facilitate transfers for estate planning purposes and transfers under domestic relations orders.

Form S–8 is available to register the offer and sale of securities to the issuer's employees [8] in a compensatory or incentive context. In 1990, we adopted substantial revisions to Form S–8,[9] including making the form effective immediately upon filing and abbreviating the disclosure format. We permitted the delivery of regularly prepared materials advising employees about benefit plans to satisfy Securities Act prospectus delivery requirements, eliminating the need to file and deliver a separate prospectus that duplicates this information. This treatment reflected a distinction we traditionally have drawn between offerings to employees primarily for compensatory and incentive purposes and offerings for capital-raising purposes. The compensatory purpose of the offering and employees' familiarity with the issuer's business through the employment relationship justify the use of abbreviated disclosure that would not be adequate in a capital-raising transaction.[10]

The 1990 revisions also made Form S–8 available for offers and sales of securities to consultants and advisors. To be eligible, a consultant must provide the issuer *bona fide* services *not* in connection with the offer or sale of securities in a capital-raising transaction. There did not appear to be a reason to distinguish between transactions with regular employees and transactions with consultants or advisors, as long as securities are issued for compensatory rather than capital-raising purposes.

A. Abuses of Form S–8

Since the 1990 revisions, some issuers and promoters have misused Form S–8 as a means to distribute securities to the public without the protections of registration under Section 5 of the Securities Act. For example, the issuer registers on Form S–8 securities nominally offered and sold to employees or, more commonly, to so-called ''consultants.'' These persons then resell the securities in the public markets, at the direction of the issuer or a promoter. In some cases, the consultants or employees perform limited or no additional services for the issuer. The consultants or employees then either remit to the issuer the proceeds from these resales, or apply those proceeds to pay expenses of the issuer that are not related to any service provided by the consultants or employees.[11]

Registration of the shares on Form S–8 does not accomplish Section 5 registration of these public sales. The

[1] 17 CFR 230.401.

[2] 17 CFR 230.405.

[3] 15 U.S.C. 77a *et seq.*

[4] 17 CFR 228.402 and 17 CFR 229.402.

[5] 17 CFR 239.13.

[6] 17 CFR 239.16b.

[7] See also Securities Act Release No. 7505 (Feb. 17, 1998) [63 FR 9632], adopting amendments to Regulation S [17 CFR 230.901 *et seq.*]; Release No. 39670 (Feb. 17, 1998) [63 FR 9661] under the Securities Exchange Act of 1934 (''Exchange Act'') [15 U.S.C. 78a *et seq.*], proposing amendments to Exchange Act Rule 15c2–11 [17 CFR 240.15c2–11]; Securities Act Release No. 7541 (May 21, 1998) [63 FR 29168], proposing amendments to Rule 504 [17 CFR 230.504]; Securities Act Release No. 7644 (Feb. 25, 1999), adopting amendments to Rule 504; and Exchange Act Release No. 41110 (Feb. 25, 1999), reproposing amendments to Rule 15c2–11.

[8] For this purpose, ''employees'' also includes the employees of the issuer's subsidiaries or parents. See General Instruction A.1(a) to Form S–8.

[9] Securities Act Release No. 6867 (June 6, 1990) [55 FR 23909].

[10] Form S–8 also permits incorporation by reference of the registrant's Exchange Act reports without regard to the length of the issuer's reporting history or the aggregate market value of its securities held by the nonaffiliated public (the issuer's ''public float''). Incorporation by reference from Exchange Act reports into a Securities Act registration statement is not otherwise available unless the issuer satisfies the eligibility requirements for Form S–2 [17 CFR 239.12], Form S–3, Form F–2 [17 CFR 239.32] or Form F–3 [17 CFR 239.33].

[11] See, *e.g., In the Matter of Spectrum Information Technologies, Inc.* (''*Spectrum*''), Securities Act Release No. 7426, Exchange Act Release No. 38774, Accounting and Auditing Enforcement Release No. 930 (June 25, 1997); *SEC* v. *Hollywood Trenz, Inc.* (''*Hollywood Trenz*''), Litigation Release No. 15730, Accounting and Auditing Enforcement Release No. 1032 (May 4, 1998).