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**Amendments Increase  
Attractiveness of Rule 701**

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The Securities and Exchange Commission has recently adopted two rule amendments that will expand the ability of foreign private issuers<sup>1</sup> that are not U.S. reporting companies to provide stock-based compensation to their U.S. employees. Specifically:

- Effective March 4, 2008, the financial statements delivered to employee stock plan participants to satisfy the Rule 701 registration exemption under the Securities Act of 1933, as amended (Securities Act) for securities offered and sold under compensatory arrangements, may be prepared in accordance with, in lieu of U.S. GAAP, International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB).
- Effective December 7, 2007, compensatory stock options that meet certain criteria no longer independently trigger reporting requirements under the Securities Exchange Act of 1934, as amended (Exchange Act).

However, although these rule amendments are helpful, there remains for many foreign private issuers a potential trap arising from their ordinary-course financial reporting schedule and the disclosure requirements discussed below. Specifically, foreign private issuers that report financial results on a semiannual basis will continue to face a “gap period” each year from the end of their first semester until half-year results are released when their public financial statements will not meet the requirement that they be no more than 180 days old when used in connection with the offer of stock-based compensation to U.S. employees.

## Background

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Any offer and sale of securities by a nonreporting company to employees, directors, or consultants who are residents of the United States raises two issues under the U.S. securities laws.

First, any offer and sale must be registered under the Securities Act unless an exemption is available. While registration of employee stock compensation arrangements is generally not practicable for an entity that is not already subject to the reporting requirements of the Exchange Act, Rule 701 provides a helpful exemption.

Second, a company meeting a minimum asset value and having a class of equity securities held by more than 500 persons worldwide, including more than 300 U.S.

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1. A “foreign private issuer” is defined as any foreign issuer other than a foreign government, except an issuer meeting the following conditions:
1. More than 50% of the issuer’s outstanding voting securities are directly or indirectly held of record by residents of the United States; and
  2. Any of the following:
    - a) The majority of the executive officers or directors are United States citizens or residents;
    - b) More than 50% of the assets of the issuer are located in the United States; or
    - c) The business of the issuer is administered principally in the United States.

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residents, must either register the class under Section 12(g) of the Exchange Act, and thereby become a U.S. reporting company, or claim an exemption from registration afforded by Rule 12g3-2(b).

A discussion of the Rule 701 Securities Act exemption and the Exchange Act implications of a foreign private issuer's equity compensation plans, and the impact of the recent rule amendments, follows.

## Rule 701

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Rule 701 under the Securities Act provides a Securities Act registration exemption for securities issued under compensatory arrangements by issuers that are not subject to the reporting requirements of the Exchange Act of 1934, subject to the following criteria:

- The aggregate sales price or amount of securities sold in any consecutive 12-month period in reliance on Rule 701 (for options, this is measured at the time of grant based on the exercise price) is limited to the greatest of:
  - \$1,000,000;
  - 15% of the total assets of the issuer; and
  - 15% of the outstanding amount of the class of securities being offered.

Typically, issuers are not restricted by this limitation, as it is unusual for more than 15% of a class of shares to be issued in any year to employees.

- The company must deliver to plan participants a copy of the compensatory plan and, if the aggregate sales price or amount of securities sold during any consecutive 12-month period exceeds \$5,000,000, the following additional disclosures:
  - A summary of the material terms of the plan.
  - Information about the risks associated with an investment in the company.
  - Financial statements prepared under, or reconciled to, U.S. GAAP, or, effective March 4, 2008, under IASB IFRS without reconciliation to U.S. GAAP. The financial statements must include a balance sheet as of a date within 180 days, along with statements of income, cash flows, and stockholder's equity for two complete fiscal years and for any interim period from the end of the last fiscal year to the balance sheet date. Rule 701 does not itself require that the financial statements be audited; however, if the issuer has the financials audited for any other reason, then it must provide the audited financials for purposes of Rule 701 disclosure.

Notwithstanding the benefits of the rule change, Rule 701 still contains a potential obstacle for a foreign private issuer. Many public non-U.S. companies report financial results on a semiannual basis. As a result, there is a blackout period each year during which Rule 701 is not available. Specifically, from the last day of the first semester (June 30 for a calendar-year company) until the half-year results are released and provided to plan participants, the issuer's financial statements will be more than 180 days old and, accordingly, Rule 701 would not be available. This means the issuer should neither grant new equity awards nor allow the exercise of options during this blackout period.

While there is no express provision in Rule 701 requiring that the disclosure be made in English, the general disclosure obligations of the U.S. securities laws would suggest that the information must be provided to plan participants in a form that they can readily comprehend. This would result in a de facto requirement to provide disclosure in English in most cases.

Securities sold under Rule 701 are deemed to be "restricted securities" under U.S. law, and, accordingly, there are restrictions on the ability of the holders to resell them in the United States.

While Rule 701 exemption provides relief from the registration requirements of the Securities Act, the general disclosure/liability provisions of the U.S. securities laws would continue to apply. An employee who purchases shares as part of a compensation plan, like any other purchaser of securities from the company, must be provided with accurate information regarding the company. Any employee who purchases securities from the employer based upon a material misstatement or omission by the company could proceed against the company.

## Exchange Act Reporting Requirements

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A company with a class of equity securities held by more than 500 persons and with a minimum amount of total assets (\$1 million or \$10 million for a foreign private issuer that is not quoted on an automated interdealer quotation system; see Rule 12g-1) must become a reporting company under Section 12(g) of the Exchange Act within 120 days of the end of the year in which the company exceeds the two thresholds. Rule 12g3-2(a) provides foreign private issuers a broad exemption from this requirement as long as the number of holders resident in the United States does not exceed 300.

For issuers likely to exceed 300 United States holders, a second exemption, Rule 12g3-2(b), is available. As currently in effect, this rule provides that the exemption, which must be claimed prior to the time the company is required to register as a reporting company, requires the company to publicly furnish to the SEC (or post on its website) all material disclosures otherwise made public under the rules or practices of the home country.<sup>2</sup>

Two issues under the Exchange Act arise from stock-based compensation provided to U.S. employees (assuming in each case that the total asset minimum is recorded):

- If, as a result of the plan, the number of U.S. holders of a class of the issuing company's shares were to surpass 300, the company would be obliged to become a reporting company by registering under Section 12 of the Exchange Act. Registration can be avoided by claiming the Rule 12g3-2(b) exemption.
- The second issue involves stock options and arises because stock options are viewed as a separate class of equity securities. Until recently, if there were more than 300 U.S. option holders and more than 500 worldwide, the issuer could be required to become a reporting company under the Exchange Act or claim the Rule 12g3-2(b) exemption, even if the class of shares underlying the options qualified for the Rule 12g3-2(a) exemption. However, in December 2007, the SEC amended Rule 12h-1 to address this issue. Under the newly added subsection (f), options will be exempt from

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2. On February 13, 2008, the SEC proposed significant amendments to Rule 12g3-2(b). As amended, the exemption would no longer be based upon the number of U.S. holders; rather, it would look to the relative trading volume in the United States compared to the issuer's primary exchange. The comment period on the proposal extends until April 25, 2008. The final rule amendment will be the topic of a future white paper.

triggering Exchange Act reporting requirements as long as the following conditions are met:

- The company is not already a reporting company
- The stock options are issued under a written compensatory plan
- Stock options are held only by employees and other individuals, such as consultants, eligible to participate in a Rule 701 plan and the permitted transferees described below
- Stock options and, prior to exercise, the underlying shares are not transferable other than to family members, through gifts or domestic relations orders, or to an executor or guardian upon the death or disability of the holder (or to the issuer or upon a change of control)
- The stock options and, prior to exercise, the shares issueable upon exercise are restricted as to any pledge
- The company agrees in the written plan (or a stock option or other agreement) to provide certain information to option holders for as long as the issuer is relying on the exemption

The information required to be provided is the same as that required for Rule 701, including the financial statements, and as of March 4, 2008, as with Rule 701, these may be prepared under IASB IFRS. This information must be provided every six months, with the financial statements not being more than 180 days old.

While this rule amendment is helpful, it should be noted that, as discussed above, for companies that report on a half-year basis, additional steps may be required. As with Rule 701, from the last day of the first semester until half-year results are released, financial statements are going to be more than 180 days old. For Rule 701, the annual imposition of the “blackout” period alleviates the problem. However, for Exchange Act purposes, it would appear that a company that will have an annual “gap period” would be unable to undertake in the plan to provide the information. This likely renders Rule 12h-1 unavailable. Accordingly, a company in this situation must either provide plan participants with updated financial statements (which need not be audited) to comply with Rule 12h-1, or claim the Rule 12g3-2(b) exemption.

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