



Alerts

SEC Exempts Restricted Stock Units From Exchange Act Registration

February 28, 2012

Hinshaw Alert

Many start-ups award employees equity in the form of stock options, restricted stock units (RSUs) or other equity-based awards. This is done to reward employees, but also as a cost-savings measure because start-ups prefer to hoard cash when possible, using equity awards in lieu of a portion of a person's salary. These awards are distributed to a broad range of employees, including officers and middle- and lower-level employees, directors and consultants. These awards help a company attract, retain and motivate these individuals. As the start-up grows and adds employees, the number of persons holding these awards increases significantly. In some situations, a start-up may have several hundred employees holding such equity awards (e.g., Google, Facebook, Starbucks).

The problem is that Section 12(g) of the Securities Exchange Act of 1934, as amended (1934 Act), and Rule 12g-1 thereunder require any company with assets in excess of \$10 million and a class of equity securities held of record by 500 persons or more to register that class of equity securities under the Securities Exchange Act (1934 Act) unless an exemption from registration is available.

Rule 12h-1(a) exempts

[a]ny interest or participation in an employee stock bonus, stock purchase, profit sharing, pension, retirement, incentive, thrift, savings or similar plan which is not transferable by the holder except in the event of death or mental incompetency, or any security issued solely to fund such plans.

This exemption, however, does not apply to stock options or RSUs.

In 2007, the U.S. Securities and Exchange Commission (SEC) exempted certain compensatory stock options (but not the shares underlying such options) from the 1934 Act's registration requirements (SEC Release No. 34-56887 (December 7, 2007)). The SEC's exemption did not apply to RSUs. The SEC has granted no-action relief from Section 12(g) registration requirements relating to RSUs to individual companies including Facebook, Twitter and Zynga (Facebook, Inc. (October 14, 2008); Twitter, Inc. (September 13, 2011); and Zynga Inc. (June 17, 2011)). Each of these no-action letters, however, is limited to the specific facts and circumstances of the company receiving the relief.

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As a consequence, a company that issues RSUs to 500 or more holders of record could not rely on these letters and would be required to file a 1934 Act registration statement and become subject to the 1934 Act's reporting requirements.

On February 13, 2012, the SEC issued a global no-action letter that grants relief from the 1934 Act registration requirement when a company reaches the 500-holder-of-record limit due to the issuance of RSUs (*Fenwick & West LLP* (February 13, 2012)), <http://sec.gov/divisions/corpfm/cf-noaction/2012/fenwickwest021312-12g.htm> (Letter).

The SEC's position is limited to RSUs that meet the conditions specified in the Letter; furthermore, the Letter does not cover other securities that a company may issue.

RSUs

RSUs are typically issued under written compensatory equity incentive plans and are only awarded to the company's employees, directors and consultants. An RSU represents the right to receive a specified number of shares of company common stock upon the attainment of certain conditions. These conditions may be time-based, providing they become exercisable over a period of years, or performance-based, providing that they become exercisable after certain performance milestones have been met. In addition, they may become exercisable upon the occurrence of a future event such as a change in control or an initial public offering. Upon the satisfaction of the conditions, the company may issue shares of the company's stock, cash (equal to the fair market value of the shares) or some combination of the two.

Holders of RSUs do not own shares of the company's common stock. Nor do they have voting, dividend, liquidation or other rights. They also are not shown as stockholders in the company's records.

SEC Letter

The SEC has stated that it will not object if a company does not comply with the registration requirements of Section 12(g) of the 1934 Act when the number of record holders of a company's RSUs exceeds 500. The RSUs must be granted pursuant to a written compensatory equity incentive plan and are subject to certain terms and conditions discussed below. A company may rely on the Letter until the company becomes subject to 1934 Act registration or reporting requirements with respect to any other class of its securities.

To rely on the Letter, a company must ensure that:

- It is not subject to the registration or reporting requirements of the 1934 Act.
- The RSUs are issued pursuant to a written compensatory equity incentive plan established by the company, a parent or subsidiary of the company, or a majority-owned subsidiary of the company's parent.
- RSU holders are provided with the information specified in 1934 Act Rule 12h-1(f)(vi) (and under the conditions described therein), which includes certain financial statements and other information (as specified in Rule 701(c)(3), (4) and (5) of the Securities Act of 1933, as amended (1933 Act)), until such time as the company becomes subject to 1934 Act's reporting requirements or is no longer relying upon the Letter.
- The RSUs must be held by the persons described in Rule 701(c) under the 1933 Act—employees, directors, and consultants of the company and certain transferees (as described below).
- The RSUs may only be transferable only to: (1) family members (as defined in Rule 701(c)(3)) by gift or domestic relations order or to an executor or guardian upon the holders' death or disability; (2) the company; or (3) in connection with a change of control or other acquisition transaction involving the company, if after such transactions the RSUs will not be outstanding and the company will no longer be relying upon the Letter.
- The RSUs must be restricted under the written equity incentive plan, written agreement, or the company's organizational documents (charter, bylaws) as to any pledge, hypothecation, or other transfer, including any short position, any put equivalent position (as defined in 1934 Act Rule 16a-1(h)) or any call equivalent position (as defined in Rule 16a-1(b)), by the RSU holder prior to the settlement of the RSU (except as described in the previous bullet point).
- A transferee of an RSU may only transfer the RSU upon his or her death; the restrictions on subsequent transfer must be included in the company's written compensatory equity incentive plan, written agreement, or the company's organizational documents, and acknowledged in writing by such transferee.



Because the SEC has opted to issue a global no-action letter, companies will be able to rely on the Letter without taking any further action. As a consequence, they will not be required to file a 1934 Act registration statement and become subject to the 1934 Act reporting requirements by virtue of issuing RSUs to 500 or more persons.

Compliance With State Securities Laws

Even though a company's RSU program may fall within the scope of the Letter, a company still must ensure that the issuance of such awards are exempt under the securities laws of the state where the recipient resides.

Start-Ups

Prior to reaching the 500 person threshold, companies that intend to issue equity awards, such as stock options and RSUs, may rely on 1933 Act Rule 701. Rule 701 exempts sales of securities by nonpublic companies pursuant to written benefit plans and compensation contracts for the benefit of employees, officers, directors, consultants or advisors, and family members of these individuals who acquire the shares through gifts or domestic relations orders.

Under this exemption, sales of the securities during any 12-month period may not exceed the greater of: (1) \$1 million; (2) 15 percent of the company's total assets; or (3) 15 percent of the outstanding securities of that class.

Specific, detailed disclosure (as described in Rule 701(3), (4) and (5)) must be made to participants if the aggregate sales price exceeds \$5 million during any 12-month period.

The SEC is wary of compensating consultants or advisors for selling stock by giving them Rule 701 shares. Rule 701 is available to consultants and advisors, provided that: (1) they are natural persons; (2) they provide bona fide services to the company, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of the company's parent; and (3) 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 company's securities.

Rule 701 securities are "restricted securities" and resales must be registered or exempt. In addition, a company still must ensure that the issuances of such awards are exempt under the securities laws of the state where the recipient resides.

For further information, please contact [Tim Sullivan](#) or your regular [Hinshaw attorney](#).

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