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Save The Date

**FIDUCIARY SUMMIT
LEXINGTON, KENTUCKY
June 7, 2018**

**ANNUAL EMPLOYEE BENEFITS SEMINAR
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August 16, 2018**

MORE DETAILS TO COME!

**JUST BECAUSE YOUR COMPANY IS
PRIVATELY HELD DOESN'T MEAN
THE SEC ISN'T WATCHING**

Daniel N. Janich

Recently the SEC slapped a \$160,000 fine on Credit Karma, a privately-owned California tech company, for violating the registration and disclosure requirements of Rule 5 of the Securities Act of 1933 when it offered almost \$14 million in stock options to its employees. But you may ask: “I thought the securities laws applied only to public companies.” How did a privately held company violate SEC rules in the first place? You must first understand the limits of the SEC Rule 701 exemption.

WHAT IS SEC RULE 701?

Before addressing the violation involved, you will need a fuller understanding of SEC Rule 701. The Securities Act of 1933 requires an issuer to register securities with the Securities and Exchange Commission (SEC) before offering or selling them to the public. Rule 701 provides a federal exemption from registration to private companies who offer or sell their securities to their employees, officers and directors, pursuant to a written compensatory benefit plan, where the total offer or sales during a 12-month period do not exceed the greater of:

- \$1 million
- 15% of the issuer's total assets (measured at the most recent balance sheet date) or
- 15% of all the outstanding securities of the class (measured at the most recent balance sheet date)

Rule 701 also requires a private company issuing securities, whose sale price in the aggregate exceeds \$5 million during any 12-month period, provide to its recipient employees certain disclosure materials relating to the offer or sale, including:

- A copy of the summary plan description (if the securities are issued as part of an ERISA plan)
- A summary of the plan’s material terms (if the securities are not part of an ERISA plan)
- Risk factors associated with the investment and
- Financial statements required under Regulation A, Form 1-A dated within 180 days (audited financial statements to be provided if available)

WHAT GOT CREDIT KARMA IN TROUBLE WITH THE SEC?

In an enforcement action, the first of its kind, the SEC alleged “From October 2014 to September 2015, Credit Karma issued approximately \$13.8 million in stock options to its employees and failed to comply with the disclosure requirements of Rule 701, even though senior executives were aware of Rule 701.” SEC Administrative Proceeding, March 12, 2018. Notably, Credit Karma failed to provide financial statements and risk disclosures to its own employees that were readily available and provided to potential institutional investors.

SEVERAL TAKEAWAYS

- Private companies should develop written policies and procedures dealing with equity-based compensation to ensure their compliance with Rule 701 limits.
- Private companies should develop written policies and procedures that address how financial disclosures are to be disseminated so as to safeguard the confidentiality of the financial information while still complying with Rule 701.
- Private companies should put into place processes and procedures that ensure as appropriate that timely reporting and disclosures are provided to employees before the Rule 701 \$5M threshold is triggered in any 12-month period.
- Securities compliance issues pop up in a variety of contexts, and in transactions that involve equity issued to not just employees. Boards of private companies should regularly consult with experienced legal counsel on securities compliance issues--just as public companies already do--to review their governance processes and ensure ongoing securities compliance.
- Now that the Tax Cuts and Jobs Act of 2017 limits deductible compensation for top executives of public companies, private companies may begin to see a recruiting playing field which encourages them to compete for top executives by providing an increasing amount of equity incentives that will likely trigger Rule 701 limits.

For more information on the application of federal and state securities laws on privately held company operations, please contact Daniel N. Janich at (312) 332-4222; djanich@holifieldlaw.com.

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