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Privately Held Companies & the SEC: New Legislation Doubles Rule 701 Soft Cap Limit

Daniel N. Janich

In our e-alert last April entitled "Just Because Your Company Is Privately Held Doesn't Mean The SEC Isn't Watching" we discussed the $160,000 fine assessed by the SEC against Credit Karma, a privately-owned California tech company, for violating the registration and disclosure requirements of Rule 5 of the Securities Act of 1933.

We cautioned our readers as to the limits of the registration exemption requirements under SEC Rule 701 and observed that privately held companies issuing share-based compensation to employees may easily and perhaps inadvertently trip themselves up by exceeding the Rule 701 exemption caps as Credit Karma did when it offered almost $14 million in stock options to its employees without complying with Rule 5 registration and disclosure requirements.

On May 24, 2018 President Trump signed into law the Economic Growth, Regulatory Relief, and Consumer Protection Act (Economic Growth Act) that rolled back some of the regulatory requirements that were imposed on banks by the Dodd-Frank Wall Street Reform and Consumer Protection Act that was enacted after the 2008 financial crises. Buried among the 73 pages of the Economic Growth Act is Section 507, a provision entitled "Encouraging Employee Ownership" that makes a significant change to Rule 701. Under the new law the $5 million "soft cap limit" for Rule 701 exemption from additional disclosures required by Rule 5 has been increased. In fact, the limit has doubled. Section 507 of the Growth Act directs

the SEC to revise Rule 701 within 60 days of enactment (anticipated to be in mid to late July 2018) to increase the cap amount to $10 million and thereafter to index it for inflation every five years to reflect changes in the Consumer Price Index for Urban Consumers (CPI-U) rounding to the nearest $1 million.

This change should make it easier—particularly for larger privately held companies — to offer share-based compensation to their employees without bumping up against the enhanced Rule 701 cap limits. The SEC requirements involved here do not require a showing of bad intent, that is, no proof is required that the company "knowingly" violated them before a hefty fine may be imposed. The company issuing its shares to employees is required to satisfy either the exemption requirements or registration and disclosure requirements. If neither, it commits a serious violation of our securities laws.

A privately held company considering adoption of a share-based compensation plan for its employees, directors or contractors is advised at the outset to consult with experienced benefits counsel who is thoroughly familiar with applicable SEC requirements and exemptions to avoid falling into a trap for the unwary. Privately held companies that have already adopted a share-based compensation plan without having addressed previously this issue should determine whether it satisfies the cap limits for exemption under Rule 701.

If you need further information on how federal and state securities laws apply to your privately held company share-based plans or operations, please contact Daniel N. Janich at (312) 332-4222 or djanich@holifieldlaw.com.
