

## Harter Secrest &amp; Emery LLP

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## SECURITIES AND EXECUTIVE COMPENSATION

**SEC BRINGS RULE 701 ENFORCEMENT ACTION**

During March, the Securities and Exchange Commission (“SEC”) brought an [enforcement action](#) against Credit Karma, Inc. (“Credit Karma”), a private company headquartered in San Francisco, California, for failure to comply with Rule 701 (“Rule 701”) of the Securities Act of 1933, as amended (“Securities Act”). This is the first enforcement action to result from a broad SEC investigation into Rule 701 option-granting practices of late-stage private companies.

**Background**

Pursuant to Section 5 of the Securities Act, companies may not offer or sell securities to the public without registering the transaction with the SEC or having a valid exemption. Rule 701 provides an exemption from the registration requirements of Section 5 for issuers not subject to the reporting requirements of the Exchange Act of 1934 (“Exchange Act”). Pursuant to Rule 701, issuers may offer and grant awards of securities to employees, officers, directors, and other specified individuals under written compensatory benefit plans provided total sales of stock during a 12-month period do not exceed the greatest of: (i) 15% of its total assets, measured at its most recent balance sheet date; (ii) 15% of the outstanding class of stock subject to the awards, measured at its most recent balance sheet date; or (iii) \$1 million. If companies issue more than \$5 million in securities during any consecutive 12-month period, they must deliver additional information, including financial information, risk disclosures, and a summary of the material terms of the plan, to all participants within a reasonable period of time before the date of sale.

**SEC Enforcement Action**

Credit Karma granted stock options to its employees under its stock plans and Equity Incentive Plan since 2011. In order to calculate the aggregate amount of securities sold during any consecutive 12-month period, Credit Karma used a 12-month offering period beginning October 1 and ending September 30. From October 1, 2014 through September 30, 2015, Credit Karma granted stock options worth approximately \$13.8 million to its employees, and therefore, Credit Karma had an obligation to deliver additional disclosure information. Credit Karma failed to provide the required disclosure until July 19, 2016, citing concerns for confidentiality. Since Credit Karma did not comply with the requirements of Rule 701, the SEC concluded that Credit Karma violated Section 5 of the Securities Act and did not have a valid exemption from registration. The SEC ordered Credit Karma to cease and desist from committing or causing any further securities registration violations, and Credit Karma consented to a civil penalty in the amount of \$160,000.

**Takeaways**

This enforcement action is a reminder to all private companies and all non-reporting foreign companies that compliance with the requirements of Rule 701 is essential for all equity awards to employees to avoid violating U.S. securities laws. It is clear from this action that the SEC is concerned that private companies may not be providing the disclosure mandated under Rule 701 to their employees. In addition, the Credit Karma action illustrates that a company’s concern regarding confidentiality is not a valid reason to avoid complying with the Rule 701 disclosure requirements. The SEC has recognized that private companies do

have legitimate confidentiality concerns when providing non-public financial information to employees and has provided guidance in the form of [Compliance and Disclosure Interpretations](#) issued in November 2017 about how companies may protect information while relying on Rule 701.

If you would like more information regarding compliance with SEC rules, including Rule 701, and SEC enforcement actions, please contact a member of Harter Secrest & Emery LLP's Securities or Executive Compensation Group. For information, visit [www.hselaw.com](http://www.hselaw.com).

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