LOS ANGELES & SAN FRANCISCO

Daily Journal

www.dailyjournal.com

THURSDAY, JUNE 1, 2017

PERSPECTIVE

Tips for startups to avoid running afoul of securities laws

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Stock options and other equity awards (such as restricted stock and restricted stock units (RSUs)) have historically been a common feature of the compensation packages offered by many start-up companies to their employees and consultants. Yet many companies are often unaware of the pitfalls of the relevant securities laws. Breaking securities laws, even unwittingly, can have serious consequences for a company, and like other parts of your business, avoiding a problem is usually a lot cheaper than trying to fix it later.

The most common way for start-up companies to comply with state and federal securities laws when granting equity awards is by reliance on what is referred to as "Rule 701" — a deceptively complex and technical rule. Below are a few key considerations to help you ensure that this rule is available for use by your company.

VENTURE CAPITAL CORNER

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Equity Award Issuance Requires Written Plan or Agreement

Companies may rely on Rule 701 only where the equity awards that they grant are granted under a written plan or agreement. It is not uncommon, in the early days of a company, for founders to grant options to friends in exchange for freelance work (for example, writing code for the company's prototype or product). Among the myriad of issues that such an informal arrangement gives rise to, these handshake deals would not fall under Rule 701. This could result in federal securities laws violations (and the securities laws of many states that require Rule 701 compliance for exemption from state registration requirements). In turn, this could raise flags when sophisticated investors (such as most Silicon Valley venture capital funds) do a due diligence review of the company in connection with a potential investment. This is one reason to use an adequate written equity incentive plan from the very start, and to document all equity award grants using individual awards agreements.

Sky Is Not the Limit

There is a maximum number of awards that can be granted in reliance on Rule 701 in any given 12-month period. Companies will have to find another way to comply with securities laws if this threshold is exceeded.

The maximum threshold is determined using a technical and complex formula. To summarize, the aggregate purchase price or amount (as determined under Rule 701) of the shares subject to equity awards that may be granted in reliance on Rule 701 during any consecutive 12-month period cannot exceed the greater of $1 million, 15 percent of the company's assets as of the end of its last fiscal quarter or year, and 15 percent of the total number of shares of the same class outstanding as of the company's last fiscal quarter or year.

Basic Disclosure Requirement

Regardless of how many equity awards are granted in reliance on Rule 701, the company must deliver to the grantees a copy of the equity incentive plan or agreement governing their awards. Typically, this is done by delivering the equity incentive plan and the individual award agreement at the time, or shortly after, the award is granted (individual award agreements typically incorporate by reference the terms of the equity incentive plan of the company under which the award is granted).

More Money, More Disclosure: the Enhanced Disclosure Requirement

In addition to meeting the basic disclosure requirement described above, a company must provide grantees additional disclosure if the aggregate purchase price or amount (as determined under Rule 701) of the awards granted in reliance on Rule 701 exceeds $5 million in any 12-month period (a bill currently pending in the U.S. Senate would increase this threshold to $10 million). The calculations are again technical and complex. For later-stage companies, however, it is entirely possible to reach this $5 million threshold long before exceeding the thresholds described above. Therefore, it is important for companies to monitor how close they are to this enhanced disclosure threshold and to take adequate steps to avoid providing enhanced disclosure, if needed.

If the enhanced disclosure threshold is reached, the company must make available, among other things, a discussion of risk factors associated with an investment in the company's securities (similar to and in the same level of detail as the risk factors provided in a public company's prospectus or annual report) and financial statements prepared in accordance with generally accepted accounting principles that may be no older than 180 days. The enhanced disclosure materials must be provided to optionees a reasonable time before they exercise their options, and to restricted stock and RSU holders before the awards are granted.

The prospect of handing over financial statements to rank-and-file employees and consultants is a daunting thought for many private companies. Therefore, the desire to keep financial information confidential must be weighed against the need to provide equity incentives to employees and consultants. The enhanced disclosure materials typically take weeks if not months to prepare, again highlighting the need for companies to continuously monitor the $5 million threshold. It is not unusual for a "unicorn" company to make the enhanced disclosure available via a secured virtual data room or portal only.

Conclusion

Rule 701 is an important facet of federal securities laws (and state securities laws in states that condition compliance with state law in part on compliance with Rule 701), and enables start-up companies, small and large, to provide crucial equity compensation to those who help make them a success. However, the regulatory requirements can be deceptively complex and a host of pitfalls must be carefully navigated to avoid potentially costly mistakes.

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