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SEC Proposes Exemptions From Registration Requirements for Compensatory Employee Stock Options Under Section 12(g) of the Securities Exchange Act of 1934

On July 5, 2007, the Securities and Exchange Commission (“SEC”) issued two proposals aimed at exempting certain issuers from registering compensatory employee stock options pursuant to Section 12(g) of the Securities Exchange Act of 1934 (the “Exchange Act”).¹ If adopted, the proposals would amend Rule 12h-1 of the Exchange Act. The first proposal would exempt private, non-reporting issuers from registering compensatory employee stock options issued under employee stock option plans. The second proposal would exempt public issuers that have registered the class of equity security underlying the compensatory employee stock options under Section 12 from having to also register the stock options. Both exemptions would only apply to issuers with 500 or more holders of record of a class of equity security and assets in excess of \$10 million at the end of its most recently ended fiscal year. The exemptions would apply only to compensatory employee stock options issued under written stock option plans that are limited to employees, directors, consultants, and advisors of the issuer, its parents, or majority-owned subsidiaries of the issuer or its parents.²

In the past, companies seeking Section 12 registration exemptions for compensatory employee stock option plans have had to rely on SEC no-action letters. The SEC hopes that its proposals, if adopted, would provide more certainty to companies regarding under what circumstances their compensatory stock option plans would be exempted from Section 12 registration requirements. In addition, the proposals would help private companies avoid becoming subject to the registration and reporting requirements of the Exchange Act before they are prepared to meet the compliance burdens attendant upon being a public reporting company. The proposals would not affect the registration requirements mandated by the Securities Act of 1933, as amended (the “Securities Act”), or the application of the Exchange Act registration

¹ See *Exemption of Compensatory Employee Stock Options From Registration Under Section 12(g) of the Securities Exchange Act of 1934*, SEC Release No. 34-56010; File No. S7-14-07 (July 5, 2007), available at <http://www.sec.gov/rules/proposed/2007/34-56010.pdf>.

² These are the categories of individuals listed in Securities Act Rule 701(c). Rule 701 affords a safe harbor from Securities Act registration for offers and sales of securities pursuant to incentive compensation plans of non-reporting companies.

requirements to the securities underlying the stock options. The SEC seeks comments on its proposals by September 10, 2007.

I. Current Section 12 Registration Requirements

Section 12(g) of the Exchange Act requires an issuer with 500 or more holders of record of a class of equity security and assets in excess of \$10 million at the end of its most recently ended fiscal year to register that class of equity security, unless a registration exemption exists. Stock options, including compensatory employee stock options, are considered a separate class of equity security under the Exchange Act.³ Currently, there is no exemption under Section 12(g) for compensatory employee stock options. In the case of public companies that are already subject to the reporting requirements of the Exchange Act and that have more than 500 stock option holders, it has historically been unclear whether an issuer must register the options as a separate class of equity security from the stock underlying the options. Thus, the only relief large private and public employers with broad option grant programs have had in the past has been to rely on individually obtained SEC no-action letters. The uncertainty surrounding issuers' Exchange Act obligations creates a possible disincentive to use broad-based compensatory employee stock options. Because compensatory employee stock options provide a viable method for companies to recruit, retain, and motivate qualified employees, directors, and consultants, however, the SEC believes that their use should be facilitated and fostered to enhance market competitiveness.

II. Proposed Exemption for Non-Reporting Issuers

The first proposed exemption would apply to issuers that do not have a class of securities registered under Section 12 and who are not subject to Exchange Act Section 15(d) reporting requirements. The exemption would apply only to compensatory stock options and would only apply under the following conditions:

- The compensatory employee stock options are issued under written stock option plans that are limited to employees, directors, consultants, and advisors of the issuer, its parents, or majority-owned subsidiaries of the issuer or its parents.
- The compensatory employee stock options and shares received on exercise are non-transferable, except (1) to family members (as defined in Securities Act Rule 701) by gift or pursuant to a domestic relations order or (2) on the optionholder's death or disability. Transferees may not further transfer the options or shares received on exercise of the options.
- No pledges, hypothecations, gifts, or other transfers of the compensatory employee stock options, shares issued on exercise of those options, or shares of the same class of equity security as those underlying the options by the optionholder or transferee can be permitted other than transfers back to the issuer or its affiliates until the issuer becomes subject to Exchange Act reporting requirements.

³ The definition of equity security under Exchange Act Section 3(a)(11) includes any right to purchase a security (including options). Exchange Act Rule 3a-11 includes options in the definition of equity security for Exchange Act Section 12(g) and Section 16 purposes. Further, class is defined in Exchange Act Section 12(g)(5) to include "all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges."

- Neither the optionholder nor a transferee of the optionholder could make the compensatory employee stock options, the securities issued upon exercise of those options, or shares of the same class of equity security as those underlying the options the subject of a short position, a “put equivalent position,” or a “call equivalent position” (as those terms are defined in Rule 16a-1 of the Exchange Act) until the issuer becomes subject to Exchange Act reporting requirements.
- The optionholder or holder of shares received on exercise of those options would not be allowed to receive any consideration or compensation for the options, the shares issuable on exercise of those options, or shares of the same class of equity security as those underlying the options except in connection with permitted transfers.
- The issuer would include the necessary limitations and conditions either in the written stock option plans or in the terms of the written option agreements. Further, the issuer must include the transferability restrictions on the shares received on exercise of the options in the issuer's by-laws, certificate of incorporation, or stock purchase or stockholder agreement with the exercising optionholder or holder of shares received on exercise of an option.

Several other important aspects of this exemption include:

- The exemption would apply only to stock options and not to the shares underlying the options. Companies must still apply the Exchange Act Section 12 registration requirements separately to the underlying shares to determine whether registration is required.
- The exemption would terminate once the issuer becomes subject to Exchange Act Section 15(d) reporting requirements.
- The exemption would not require that there be any restriction on the timing of the exercise of the compensatory employee stock options by the optionholder, the optionholder's estate or guardian in the event of the optionholder's death or disability, or a family member who acquired the options through a gift or pursuant to a domestic relations order.
- The proposed exemption would require the issuer to provide to optionholders and holders of shares received on exercise of the stock options the following information: (1) the same risk and financial information that would be required under Securities Act Rule 701 if securities sold in reliance on that Rule exceeded \$5 million in a 12-month period;⁴ (2) financial statements that are not older than 180 days; and (3) the issuer's books and records, including corporate governance documents, to the same extent that they are available to other shareholders. The issuer would be permitted to provide this information either through physical or electronic delivery or on an Internet site. Further, while the issuer would have the option of requiring an optionholder to sign a confidentiality agreement, if the optionholder refused, the issuer would have to allow the optionholder inspection of its documents at one of the issuer's offices.

⁴ Under Rule 701, if the aggregate sales price of securities sold during any 12-month period in reliance on the Rule exceeds \$5 million, the issuer is required to deliver to investors disclosure of the terms of the plan pursuant to which the securities are sold, information about the risks of an investment in the securities, and certain financial information about the issuer.

III. Proposed Exemption for Reporting Issuers

The SEC proposal would also exempt issuers with public reporting requirements triggered by a registration of a class of equity securities under Exchange Act Section 12 from being required to register compensatory stock options. The exemption would apply to both the compensatory employee stock options and the securities underlying the options. The exemption would be available if the following conditions were satisfied:

- The compensatory employee stock options are issued under written stock option plans that are limited to employees, directors, consultants, and advisors of the issuer, its parents, or majority-owned subsidiaries of the issuer or its parents.
- The issuer has filed reports required by Exchange Act Section 13.

An issuer need not be “current” in its Exchange Act reporting to take advantage of this exemption. In addition, certain provisions of Sections 13, 14, and 16 would continue to apply to the options and securities issuable on exercise of the options. And, unlike the proposed exemption pertaining to private, non-reporting issuers, there would be no additional information requirement to fulfill since such issuers were already publicly reporting companies.

IV. Transition Provisions

The proposed exemptions would not affect the no-action relief from Exchange Act Section 12(g) registration of compensatory employee stock options that some issuers have received from the SEC. These issuers could choose to either continue relying on the letters or take advantage of the newly proposed exemptions.

In the event that a private, non-reporting issuer becomes ineligible to rely on the proposed exemption, the issuer could rely on it for an additional 60 days while it files a registration statement to register the class of compensatory employee stock options under Exchange Act Section 12(g). And, in the event that a public, reporting issuer becomes ineligible to rely on the applicable proposed exemption, it too would have 60 days to continue reliance while it files a registration statement to register the class of equity security underlying the compensatory employee stock options.

V. Conclusion

The SEC expects that these proposed exemptions will provide greater certainty to affected issuers in their compensation decisions. Further, because the exemptions are self-executing, qualified issuers will no longer have to endure the delay and costs associated with seeking no-action relief. Insofar as these exemptions eliminate possible disincentives for issuers to use compensatory employee stock options to attract and retain qualified employees, the SEC believes that these exemptions will increase issuers’ competitiveness in the market.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Jon Mark at (212) 701-3100 or jmark@cahill.com; or John Schuster at (212) 701-3323 or jschuster@cahill.com.