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

On December 3, 2007, after receiving comments on its proposal dated July 5, 2007, the Securities and Exchange Commission (“SEC”) adopted two exemptions from the registration requirements of Section 12(g) of the Securities Exchange Act of 1934 (the “Exchange Act”) for compensatory employee stock options.¹ The newly adopted exemptions will amend Rule 12h-1 of the Exchange Act. The first amendment exempts private, non-reporting issuers from registering compensatory employee stock options issued under employee stock option plans. The second amendment exempts from Section 12(g)’s registration requirements compensatory employee stock options of issuers that have registered a class of security under Section 12 or are required to file periodic reports pursuant to Exchange Act Section 13 or Section 15(d). Both exemptions apply only 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 do not extend to the class of securities underlying the issuer’s compensatory employee stock options; companies must still consult Exchange Act Section 12 in order to determine whether they must register the underlying shares.

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 believes that its exemptions will provide useful certainty to issuers in their compensation decisions and will help private issuers 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.

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.² Currently,

¹ See *Exemption of Compensatory Employee Stock Options From Registration Under Section 12(g) of the Securities Exchange Act of 1934*, SEC Release No. 34-56887; File No. S7-14-07 (Dec. 3, 2007), available at <http://www.sec.gov/rules/final/2007/34-56887.pdf>.

² 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.”

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.

II. Exemption for Non-Reporting Issuers

The first exemption applies to issuers that do not have a class of securities registered under Section 12 and who are not subject to the reporting requirements of Exchange Act Section 15(d).³ The exemption applies only to employee stock options issued for compensatory purposes and is available only under the following conditions:

- The compensatory employee stock options are issued under written stock option plans that are limited to employees and directors, consultants, and advisors of the issuer, its parents, or majority-owned subsidiaries of the issuer or its parents.⁴
- The compensatory employee stock options and, prior to exercise, shares to be received on their 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.
- There are no permitted pledges, gifts, hypothecations, or other transfers of the compensatory employee stock options or, prior to exercise, shares issuable on exercise of those options, except for transfers back to the issuer or transfers in connection with change of control or other acquisition transactions involving the issuer if, following the transaction, the options will not be outstanding and the issuer will no longer be relying on the exemption.
- The optionholder may not make the compensatory employee stock options or, prior to exercise, the securities issuable upon the exercise of those 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 the Exchange Act's reporting requirements or is no longer relying on the exemption. However, the options may be subject to repurchase rights of the issuer (or termination) in the event of an impermissible transfer, and the optionholder may participate in a change of control or other acquisition transaction involving the issuer.
- The exemption, as adopted, requires the issuer to provide to optionholders 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.⁵ Such information, including financial statements that are not more than 180 days old, must be provided to optionholders every six months. The issuer is permitted to provide the information either by physical or electronic delivery or on an Internet site. The exemption permits the disclosure provision to be conditioned on the optionholder signing a confi-

³ Section 15(d) requires an issuer to file Exchange Act reports at least during the year in which the issuer has filed a registration statement which became effective under the Securities Act of 1933 and for each year thereafter, except that this obligation is automatically suspended if the class of securities to which the registration statement related is held by less than 300 holders.

⁴ 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.

⁵ 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.

confidentiality agreement; the issuer need not provide the information if the optionholder does not agree to maintain the confidentiality of the information.

- The issuer must include the limitations and conditions to the exemption in the written stock option plans, within the terms of the individual written option agreements, or in another enforceable written agreement.

Several other important aspects of this exemption include:

- The exemption applies to all compensatory employee stock options that are issued under written compensatory stock option plans on a combined basis where the securities underlying the employee stock options are of the same class of securities of the issuer.
- The exemption does 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 exemption does not extend to any class of securities issued on exercise of the compensatory employee stock options.
- The exemption terminates upon the occasion of the issuer becoming subject to the Exchange Act's reporting requirements or in the event the issuer no longer satisfies the conditions to the exemption, outlined above.

III. Exemption for Reporting Issuers

The SEC also adopted an exemption from Exchange Act registration requirements for compensatory employee stock options of issuers that already have registered securities under Exchange Act Section 12 or are required to file periodic reports pursuant to Exchange Act Sections 13 or 15(d).⁶ This exemption is available under the following conditions:

- The options are issued pursuant to a written compensatory stock option plan.
- The class of persons eligible to receive or hold compensatory employee stock options includes those participants permitted to receive options under Securities Act Rule 701, as well as those participants permitted under an issuer's Form S-8.

Several other important aspects of this exemption include:

- Provided that the issuer has made a good faith and reasonable attempt to comply with the conditions of this exemption, the issuer may continue to rely on the exemption even if there is an "insignificant deviation" from the exemption's eligibility conditions.
- The exemption does not impose any information conditions in addition to those resulting from the registration of a class of security under the Exchange Act or arising under Exchange Act Section 15(d).
- An issuer need not be "current" in its Exchange Act reporting to take advantage of this exemption.
- For issuers required to file periodic reports under Exchange Act Section 15(d), the exemption will no longer apply once their obligation to file such reports is suspended; in order to continue to avail themselves of the exemption, these issuers must register a class of security under Exchange Act Section 12.

⁶ Though the SEC originally proposed that the exemption apply only where the issuers had registered the class of equity security underlying the compensatory employee stock options, it ultimately decided to extend the exemption to include all issuers required to file periodic reports under the Exchange Act.

IV. Transition Provisions

In the event that a private, non-reporting issuer becomes ineligible to rely on the exemption, the issuer will have 120 calendar days (from the date it became ineligible) to file a registration statement to register the class of compensatory employee stock options under Exchange Act Section 12(g). If a public, reporting issuer becomes ineligible to rely on the applicable exemption, it will be permitted up to 60 calendar days to rely on the exemption while it files a registration statement to register the class of compensatory employee stock options or a class of security.

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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; or Yafit Cohn at (212) 701-3089 or ycohn@cahill.com.