

SEC Adopts Exemptions for Compensatory Employee Stock Options from Securities Exchange Act Registration

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On November 15, 2007, the Securities and Exchange Commission adopted two exemptions from the registration requirements of the Securities Exchange Act of 1934 for compensatory stock options. The final adopting release relating to the exemptions was issued by the SEC on December 3, 2007.¹

Subject to satisfaction of the applicable conditions, the exemptions are available to:

- private, non-reporting issuers that are not required to file periodic reports under the Exchange Act; and
- issuers that are required to file reports pursuant to Exchange Act Section 13 or Exchange Act Section 15(d).

BACKGROUND

In recent years, employers, including private companies, have increasingly used compensatory stock options as a non-cash incentive to attract, retain and motivate employees. The SEC reports that since the 1990's, several private, non-reporting issuers have issued stock options to 500 or more employees, directors, and consultants.²

Under Exchange Act Section 12(g), an issuer that has 500 or more holders of a class of equity security and assets in excess of \$10 million at the end of its most recently completed fiscal year must register that class of equity security under the Exchange Act, absent an available exemption from registration. For purposes of Section 12(g), stock options constitute a class of equity security. As a result, an issuer with 500 or more holders of stock options and more than \$10 million in assets at the end of its most recently completed fiscal year would be required to register that class of options, absent an available exemption.

¹ Exemption of Compensatory Employee Stock Options from Registration under Section 12(g) of the Securities Exchange Act of 1934, Release No. 34-56887 (December 3, 2007) [17 CFR 240] ("Final Release").

² See e.g. no-action letters to Starbucks Corporation (available Apr. 2, 1992); Kinko's, Inc. (available Nov. 30, 1999); Mitchell International Holding, Inc. (available Dec. 27, 2000); AMIS Holdings, Inc. (available Jul. 30, 2001); Headstrong Corporation (available Fed. 28, 2003; and VG Holding Corporation (available Oct. 31, 2006).

Section 12(g) was created to provide holders of over-the-counter securities the same protection afforded to holders of securities listed on an exchange³ and to prevent fraud. However, its guidelines have caused many otherwise private companies to become subject to the Exchange Act registration requirements. The application of the Section 12(g) registration requirements has prompted a number of companies to seek exemptive relief from the SEC. Since the early 1990's, the SEC's Division of Corporation Finance has granted a number of these requests through no-action letters. In 2006, the Advisory Committee on Smaller Public Companies recommended in its Final Report that the SEC provide Section 12(g) registration relief for compensatory stock options.⁴ The SEC has now responded to this recommendation and codified certain exemptions from the Section 12(g) registration requirements.

EXEMPTION FOR COMPENSATORY EMPLOYEE STOCK OPTIONS FOR NON-REPORTING ISSUERS

Eligible Issuers

The first new exemption adopted by the SEC is applicable to issuers that do not have a class of securities registered under Exchange Act Section 12 and that are not subject to the reporting requirements of Exchange Act Section 15(d).

This exemption will not be available to an issuer who was required, but failed, to register another class of equity security under the Exchange Act. Moreover, this exemption will terminate if an issuer becomes required to file Exchange Act reports or if the issuer no longer satisfies the conditions to the exemption.

Eligible Stock Options

Exchange Act Section 12(g) registration relief for non-reporting issuers will be available for compensatory employee stock options issued under a written compensatory stock option plan that is limited to employees, directors, consultants, and advisors of the issuer, its parents, or majority-owned subsidiaries of the issuer or its parents.

Eligible Option Plan Participants

The availability of the exemption for non-reporting issuers is limited to stock options issued under plans where the class of eligible option holders is limited to the class of eligible option holders listed in Securities Act Rule 701, which includes:

³ House of Representatives Report No. 1418 (1964), 88th Cong., 2d Sess., HR 679, p.1. See also Section 3(c) of the Securities Act Amendments of 1964, Pub.L. 88-467; 78 Stat. 565.

⁴ Final Report of the Advisory Committee on Smaller Public Companies to the Securities and Exchange Commission, Apr. 23, 2006 at 87 ("Final Report of the Advisory Committee").

- employees, directors, general partners and trustees of the issuer, its parents, or majority-owned, direct or indirect subsidiaries of the issuer or its parents;
- officers, consultants and advisors of the issuer, its parents, or majority-owned, direct or indirect subsidiaries of the issuer or its parents;
- family members who acquire their securities through gifts or domestic relations orders; and
- former employees, directors, general partners, trustees, officers, consultants and advisors of the issuer, its parents, or majority-owned, direct or indirect subsidiaries of the issuer or its parents, provided that such persons were providing services at the time the securities were offered.

The limitations on eligible participants are intended to ensure that the exemption is limited to employee stock options issued solely for compensatory purposes and not for capital-raising or other purposes.

Option Terms

The exemption for non-reporting issuers is available only if:

- The compensatory stock options and, prior to exercise, the shares to be received on exercise of those options, cannot be transferred until the issuer becomes subject to the reporting requirements of Exchange Act Section 13 or 15(d) or is no longer relying on the exemption, except to:
 - family members by gift or pursuant to domestic relations orders; or
 - executors or guardians of an option holder upon the option holder's death or disability.

In addition, the option holders may be permitted to transfer the stock options to the issuer, or in connection with a change of control or other acquisition transaction involving the issuer, if after such transaction the stock options no longer will be outstanding and the issuer no longer will be relying on the exemption.

- The exemption for non-reporting issuers provides that, except with regard to the limited permitted transfers specified above, "an option holder cannot be permitted, prior to exercise, to pledge, hypothecate, or otherwise transfer the compensatory employee stock options or the shares underlying those options, including through a short position, a 'put equivalent position,' or a 'call equivalent position,' until the issuer becomes subject to the reporting requirements of the Exchange Act or is no longer relying on the exemption. These transfer restrictions must apply to options outstanding at the time the issuer is relying on the exemption."

The restrictions are designed to limit the development of a trading market for the stock options and the shares underlying those options until the issuer becomes subject to the reporting requirements of the Exchange Act or is no longer relying on the exemption.

The SEC originally proposed that the transferability restrictions apply not only to the stock options, but also to the underlying shares received on exercise of the options. However, several comments to the proposal suggested that private, non-reporting issuers usually already have other mechanisms, such as shareholder agreements, to restrict the transfer of shares received on exercise of stock options prior to some triggering event, such as a change of control or the issuer becoming an Exchange Act reporting company. As a result, these additional restrictions were not adopted.

Permitted Exercisability

The exemption for non-reporting issuers places no restrictions on the exercise of the compensatory stock options by the option holder, by the option holder's estate in the event of the option holder's death or disability, or by a family member who acquired the options through a gift or domestic relations order.

Required Disclosure

Every six months, the issuer must provide the option holder with the same risk and financial information that would be required under Securities Act Rule 701,⁵ if securities sold in reliance on such Rule in a 12-month period exceeded \$5 million, including financial statements that are not more than 180 days old.

The issuer can provide this information by physical or electronic delivery or with notice of its availability on an internet site and any password which may be required to so access it.⁶

The SEC believes this limited disclosure requirement should adequately protect both investors and the public interest. The SEC expects that the holder of a compensatory employee stock option likely has a higher level of involvement with and knowledge about the issuer than the average investor has about a company with which the investor is unaffiliated. Therefore, the option holder may need less information than an unaffiliated investor. Similarly, the transferability restrictions mean that option

⁵ Rule 701(e) generally requires disclosure to be provided by the issuer of the material terms of the compensatory stock option plan, information about the risks associated with investment in the stock options and financial statements of the issuer.

⁶ Compliance with the minimum disclosure standards for Securities Act Rule 701 may not necessarily satisfy the antifraud standards of the securities laws. See Rule 701(c) [17 CFR 230.701(c)].

holders have limited investment decisions to make and therefore need less information than an investor investing in an Exchange Act reporting company.

Issuer Obligation to Impose Exemption Conditions

In order to take advantage of the exemption, the issuer must include the limitations on transfer and the information delivery obligations of the exemption in the relevant written stock option plan(s), within the terms of the individual written option agreements, within its certificate of incorporation or by-laws, or in another written agreement enforceable against the issuer. As a result, in order to take advantage of the exemption, non-reporting issuers may be required to amend their stock option plan(s), option agreements or other organizational documents to conform to the requirements of the exemption. Issuers that are reporting companies as a result of the requirement of Section 15(d) may also be required to effect such amendments once they are no longer required to file reports pursuant to Section 15(d) even if such companies continue to file reports with the SEC as so-called “voluntary filers.”⁷

Registering When No Longer Eligible for Exemption

If a private, non-reporting issuer becomes ineligible to rely on the exemption for private, non-reporting issuers, it will have 120 calendar days to file a registration statement for the class of compensatory employee stock options under Exchange Act Section 12(g).

EXEMPTION FOR COMPENSATORY EMPLOYEE STOCK OPTIONS FOR REPORTING ISSUERS

The SEC has also granted an exemption from the reporting requirements for compensatory stock options for certain reporting issuers. The SEC believes this exemption will provide certainty to these issuers regarding their obligations to register options and will not adversely affect investors, as the already required filings will provide option holders with adequate information.

Eligible Issuers

The exemption provides Exchange Act 12(g) registration relief for all issuers required to file reports pursuant to Exchange Act Sections 13 or 15(d).⁸

⁷ A “voluntary filer” is an issuer who has in the past been required to file reports pursuant to Section 15(d) and continues to file Exchange Act reports even though no longer required to do so as a result of the security being held by fewer than 300 record holders, as provided in Section 15(d) of the Exchange Act.

⁸ If an issuer becomes a “voluntary filer”, the issuer will no longer be an eligible issuer under the exemption for “reporting issuers” and must either meet the conditions for the exemption for “non-reporting issuers” or must register the stock options under the Exchange Act.

Eligible Stock Options

As with the exemption for non-reporting issuers, the exemption for Exchange Act reporting issuers will only be available where the stock options are issued under a written compensatory stock option plan.

Eligible Option Plan Participants

Although the SEC originally proposed to limit the exemption to those participants permitted to be granted options under an issuer's Form S-8, the SEC ultimately decided to broaden the exemption for reporting issuers to apply to the class of eligible option holders listed in Securities Act Rule 701 as well.⁹

For reporting issuers, the SEC has also adopted a provision which permits the use of the exemption even if there is an insignificant deviation from satisfaction of the eligibility requirements of the exemption. For purposes of the exemption, the insignificant deviation is permitted if the number of option holders that do not meet the eligibility condition is insignificant both as to the aggregate number of option holders and number of outstanding options and in the future the issuer makes a good faith and reasonable attempt to comply with the eligibility requirements of the exemption.

Required Disclosure

There are no information delivery conditions required for the exemption for Exchange Act reporting issuers, other than those arising from pre-existing reporting obligations. Further, use of the exemption is not conditioned on the issuer being current in its Exchange Act reporting.

Registering When No Longer Eligible for Exemption

If an Exchange Act reporting issuer becomes a private, non-reporting issuer, it will no longer be able to rely upon the exemption for reporting issuers. Instead, it must rely on the exemption available to non-reporting issuers if it can satisfy the necessary conditions to that exemption.¹⁰

If a reporting issuer becomes ineligible to rely on the exemption for any other reason, it will have 60 calendar days to file a registration statement for the class of compensatory employee stock options under Exchange Act Section 12(g). For example, if an issuer required to file reports pursuant to

⁹ There is a substantial overlap between the Rule 701 and Form S-8 descriptions of eligibility. Note that non-reporting issuers' option holders must meet the eligibility requirements of Rule 701. See the discussion under "Exemption for Compensatory Employee Stock Options for Non-Reporting Issuers – Eligible Option Plan Participants," above for a description of eligible option holders under Rule 701(c).

¹⁰ See note 8, supra for treatment of "voluntary filers" under Section 15(d) of the Exchange Act.

Exchange Act Section 15(d) becomes no longer obligated to so file, the exemption will no longer be available. Thus, to continue to rely on an exemption, the issuer would have to either satisfy the conditions for the exemption for non-reporting issuers, or, alternatively, register a class of security under Exchange Act Section 12(g) within 60 days.

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