

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Release No. 34-56887; International Series Release No. 1305;

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**EXEMPTION OF COMPENSATORY EMPLOYEE STOCK OPTIONS FROM
REGISTRATION UNDER SECTION 12(g) OF THE SECURITIES EXCHANGE
ACT OF 1934**

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: We are adopting two exemptions from the registration requirements of the Securities Exchange Act of 1934 for compensatory employee stock options. The first exemption will be available to issuers that are not required to file periodic reports under the Exchange Act. The second exemption will be available to issuers that are required to file those reports because they have registered under Exchange Act Section 12 a class of security or are required to file reports pursuant to Exchange Act Section 15(d). The exemptions will apply only to the issuer's compensatory employee stock options and will not extend to the class of securities underlying those options.

EFFECTIVE DATE: [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER].

FOR FURTHER INFORMATION CONTACT: Amy M. Starr, Senior Special Counsel to the Director, at (202) 551-3115, Division of Corporation Finance, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are amending rule 12h-1¹ under the Securities Exchange Act of 1934.²

¹ 17 CFR 240.12h-1.

² 15 U.S.C. 78a et. seq.

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I. INTRODUCTION AND BACKGROUND

A. Proposing Release and Public Comment Letters

On July 5, 2007, we proposed amendments to Exchange Act Rule 12h-1 to provide two exemptions from Exchange Act Section 12(g)³ registration for compensatory employee stock options.⁴ The first proposed exemption applied to compensatory employee stock options of an issuer that did not have a class of security registered under Exchange Act Section 12⁵ and was not subject to the reporting requirements of Exchange Act Section 15(d),⁶ provided certain conditions were met. The proposed exemption built on a line of no-action letters issued by the staff of the Division of Corporation Finance that granted relief from Exchange Act Section 12(g) registration to private, non-reporting issuers for their compensatory employee stock options.⁷ The second proposed exemption applied to compensatory employee stock options of issuers that were required to file periodic reports under the Exchange Act because they had registered under Section 12 the class of equity security underlying those options.

In response to our request for comment on the Proposing Release, we received twelve comment letters from various persons, all of whom expressed support for the need

³ 15 U.S.C. 78j(g).

⁴ Exemption of Compensatory Employee Stock Options from Registration Under Section 12(g) of the Securities Exchange Act of 1934, Release No. 34-56010 (Jul. 10, 2007) [72 FR 37608] (“Proposing Release”).

⁵ 15 U.S.C. 78j.

⁶ 15 U.S.C. 78o(d).

⁷ 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) (“Mitchell International”); AMIS Holdings, Inc. (available Jul. 30, 2001) (“AMIS Holdings”); Headstrong Corporation (available Feb. 28, 2003); and VG Holding Corporation (available Oct. 31, 2006) (“VG Holding”).

for the proposed exemptions.⁸ Commenters expressed differing concerns about the scope of the exemptions, and the transferability restrictions and information conditions of the proposed exemption for private, non-reporting issuers. After considering commenters' views, we are adopting amendments to Exchange Act Rule 12h-1, substantially as proposed, with some modifications including:

- Exemption for private, non-reporting issuers:
 - Elimination of transferability and ownership restrictions on holders of shares issued on exercise of compensatory employee stock options; and
 - Elimination of an issuer's obligation to provide certain required information to holders of shares received on exercise of compensatory employee stock options.
- Exemption for public reporting issuers:
 - Expansion of the category of issuers eligible to rely on the exemption to include any issuer required to file periodic reports under Exchange Act Section 13⁹ or Section 15(d).

B. Employee Stock Options and Exchange Act Section 12(g)

In the 1980s, private, non-reporting issuers began using compensatory employee stock options¹⁰ to compensate a broader range of employees, including executive, middle,

⁸ See letters from American Bar Association, Committee on Federal Regulation of Securities ("ABA"); America's Community Bankers ("ACB"); Center for Audit Quality ("CAQ"); Deloitte & Touche LLP ("D&T"); Drinker Biddle & Reath LLP ("Drinker"); Ernst & Young LLP ("E&Y"); Freescale Semiconductor ("Freescale"); KPMG LLP ("KPMG"); Andrew Ross, Partner, Loeb & Loeb ("Ross"); New York State Society of Certified Public Accountants ("NYSSCPA"); Pink Sheets LLC ("Pink Sheets"); and Simpson Thacher & Bartlett LLP ("Simpson").

⁹ 15 U.S.C. 78m.

¹⁰ Throughout this release, for purposes of the exemption for private, non-reporting issuers, we use the term "compensatory employee stock options" to refer to stock options issued to employees,

and lower-level employees, directors, and consultants.¹¹ Compensatory employee stock options provide a method to use non-cash compensation to attract, retain, and motivate company employees, directors, and consultants.¹² Since the 1990s, a number of private, non-reporting issuers have granted compensatory employee stock options to 500 or more employees, directors, and consultants.¹³

Under Exchange Act Section 12(g), 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 must register that class of equity security, unless there is an available exemption from registration.¹⁴ Stock options, including stock options issued to

directors, consultants, and advisors (to the extent permitted under Securities Act Rule 701 [17 CFR 230.701]). For reporting issuers, the phrase also refers to those persons described in General Instruction A.1(a) to Form S-8 [17 CFR 239.16b].

¹¹ The National Center for Employee Ownership surveyed 275 venture capital-backed private businesses in the technology and telecommunications businesses. Of these firms, 77% provided options to all employees while 23% provided them only to select employees. “New Data Show Venture-Backed Companies Still Issue Options Broadly,” http://www.nceo.org/library/option_venturebacked.html; see also J. Hand, 2005 “Give Everyone a Prize? Employee Stock Options in Private Venture-Backed Firms,” Working Paper, Kenan-Flagler Business School, UNC Chapel Hill, available at <http://ssrn.com/abstract=599904> (“Hand Paper”) (study investigating the impacts on the equity values of private venture-backed firms of the organizational depth to which they grant employee stock options).

Securities Act Rule 701, which provides an exemption from Securities Act registration for non-reporting issuers for offerings of securities to employees, directors, consultants and advisors, and specified others, pursuant to written compensatory benefit plans or agreements, has given private issuers great flexibility in granting compensatory employee stock options to employees (and other eligible persons) at all levels. See Rule 701(c) [17 CFR 230.701(c)]; and Rule 701 Exempt Offerings Pursuant to Compensatory Arrangements, Release No. 33-7645 (Mar. 8, 1999) [64 FR 11095] (“Rule 701 Release”). See also Compensatory Benefit Plans and Contracts, Release No. 33-6768 (Apr. 14, 1988) [53 FR 12918].

¹² See Hand Paper, note 11 *supra*.

¹³ See no-action letters cited at note 7 *supra*.

¹⁴ The asset threshold was set originally at \$1 million in Section 12(g). Pursuant to its authority under Section 12(h) of the Exchange Act, the Commission has increased the amount three times; from \$1 million to \$3 million in 1982 (System of Classification for Purposes of Exempting Smaller Issuers From Certain Reporting and Other Requirements, Release No. 34-18647 (Apr. 13, 1982)[47 FR 17046]), from \$3 million to \$5 million in 1986 (Reporting by Small Issuers, Release

employees under stock option plans, are a separate class of equity security for purposes of the Exchange Act.¹⁵ Accordingly, an issuer with 500 or more optionholders and more than \$10 million in assets is required to register that class of options under the Exchange Act, absent an available exemption. While there is an exemption from Exchange Act Section 12(g) registration for interests and participations in certain other types of employee compensation plans involving securities,¹⁶ currently there is no exemption for compensatory employee stock options.

The addition of Section 12(g) to the Exchange Act in 1964 was intended “to extend to investors in certain over-the-counter securities the same protection now afforded to those in listed securities by providing that the issuers of certain securities now traded over the counter shall be subject to the same requirements that now apply to issuers of securities listed on an exchange.”¹⁷ Further, Exchange Act Section 12(g)

No. 34-23406 (Jul. 8, 1986) [51 FR 253601]), and from \$5 million to \$10 million in 1996 (Relief from Reporting by Small Issuers, Release No. 34-37157 (May 1, 1996) [61 FR 21353]).

¹⁵ Exchange Act Section 3(a)(11) [15 U.S.C. 78c(a)(11)] defines equity security to include any right to purchase a security (such as options) and Exchange Act Rule 3a11-1 [17 CFR 240.3a11-1] explicitly includes options in the definition of equity security for purposes of Exchange Act Sections 12(g) and 16 [15 U.S.C. 78j(g) and 78p]. Exchange Act Section 12(g)(5) [15 U.S.C. 78j(g)(5)] defines class to include “all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges.”

¹⁶ The exemption from registration under Exchange Act Section 12(g) which is contained in Exchange Act Rule 12h-1(a), was adopted in 1965, for “[a]ny interest or participation in an employee stock bonus, stock purchase, profit sharing, pension, retirement, incentive, thrift, savings or similar plan which is not transferable by the holder except in the event of death or mental incompetency, or any security issued solely to fund such plans.” Rule 12h-1 is intended to exempt from Section 12(g) registration the same types of employee benefit plan interests as Section 3(a)(2) [15 U.S.C. 77c(a)(2)] of the Securities Act of 1933 [15 U.S.C. 77a et. seq.] exempts from Securities Act registration and, thus, does not cover stock options. See, e.g., L. Loss and J. Seligman, Securities Regulations, 3d., at §6-A-4.

¹⁷ 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.

extended the disclosure and other Exchange Act safeguards to unlisted securities as a means to prevent fraud.¹⁸

A number of private, non-reporting issuers faced with registration under Exchange Act Section 12(g) due solely to their compensatory employee stock options being held by 500 or more holders of record (as well as having more than \$10 million in assets) at the end of their fiscal year have requested registration relief from our Division of Corporation Finance.¹⁹ Since 1992, the Division has provided relief through no-action letters²⁰ to these private issuers when specified conditions were present. More recently, the Advisory Committee on Smaller Public Companies, in its Final Report, recommended that we provide Exchange Act Section 12(g) registration relief for compensatory employee stock options.²¹

As we discussed further in the Proposing Release, we believe that it is appropriate at this time to adopt two new exemptions from the registration provisions of Exchange Act Section 12(g) for compensatory employee stock options issued under employee stock option plans that are limited to employees, directors, consultants, and advisors of the issuer, its parents, and majority-owned subsidiaries of the issuer or its parents.²²

¹⁸ Senate Committee Report, No. 379 (1963), 88th Cong., 1st Sess., p. 63.

¹⁹ The Division has delegated authority to grant (but not deny) applications for exemption under Exchange Act Section 12(h). See Rule 200.30-1(e)(7) [17 CFR 200.30-1(e)(7)].

²⁰ For the conditions necessary to receive relief under these letters and orders see, e.g., the no-action letter to Mitchell International, note 7 supra (for the pre-2001 relief) and the no-action letters to AMIS Holdings, note 7 supra; ISE Labs, Inc. (available Jun. 2, 2003); Jazz Semiconductor, Inc. (available Nov. 21, 2005) (“Jazz Semiconductor”); and VG Holding, note 7 supra (for the expanded relief beginning in 2001).

²¹ 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”).

²² The exemption for private, non-reporting issuers allows compensatory employee stock options to be held only by those persons described in Securities Act Rule 701(c) [17 CFR 230.701(c)]

II. DISCUSSION OF EXEMPTIONS

We are adopting two amendments to Exchange Act Rule 12h-1 as proposed, with some modifications. These amendments will:

- provide an exemption for private, non-reporting issuers from Exchange Act Section 12(g) registration for compensatory employee stock options issued under employee stock option plans; and
- provide an exemption from Exchange Act Section 12(g) registration for compensatory employee stock options of issuers that have registered under Exchange Act Section 12 a class of security or are required to file reports pursuant to Exchange Act Section 15(d).

Given the differences between issuers that are required to file periodic reports under the Exchange Act and those issuers that do not have such an obligation, including the nature of the trading markets and the amount of publicly available information, we believe that it is appropriate to adopt separate exemptions for these different types of issuers.

(including permitted transferees), while the exemption for reporting issuers also allows options to be held by those persons described in General Instruction A.1(a) to Form S-8. Securities Act Rule 701(c) lists the categories of persons to whom offers and sales of securities under written compensatory benefit plans or contracts may be made in reliance on Securities Act Rule 701 by an issuer, its parents, and majority-owned subsidiaries of the issuer or its parents. The categories of persons are: employees (including specified insurance agents); directors; general partners; trustees (where the issuer is a business trust); officers; consultants and advisors (under certain conditions); family members who acquire their securities from such persons through gifts or domestic relations orders; and former employees, directors, general partners, trustees, officers, consultants and advisors only if such persons were employed by or providing services to the issuer at the time the securities were offered. The exemption also allows options to be transferred to (and held by) family members (as described in Securities Act Rule 701) through gifts or domestic relations orders, or to an executor or guardian of the optionholder upon the death or disability of the optionholder. For ease of discussion, in this release we use the phrase “employees, directors, consultants and advisors of the issuer” to refer to those persons described in Securities Act Rule 701(c) and transferees permitted by the exemption. For reporting issuers, the exemption will cover grants of options made prior to and after the issuer becomes subject to the Exchange Act reporting requirements.

A. Exemption For Compensatory Employee Stock Options of Issuers That Are Not Exchange Act Reporting Issuers

We believe it is appropriate to provide an exemption from Exchange Act registration, based on the factors identified in Exchange Act Section 12(h),²³ for compensatory employee stock options of issuers that are not required to file reports under the Exchange Act.²⁴ We believe that an exemption from Exchange Act registration of compensatory employee stock options for private, non-reporting issuers will provide useful certainty to those issuers in their compensation decisions and will help them avoid becoming subject to the registration and reporting requirements of the Exchange Act prior to the time they have public shareholders. The availability of this exemption is subject to specified limitations, including limitations concerning permitted optionholders, transferability, and provision of information. We believe that the conditions to the exemption and the existing statutory provisions and rules provide holders of compensatory employee stock options in private, non-reporting issuers appropriate disclosure and investor protections under the federal securities laws, given the

²³ Exchange Act Section 12(h) provides for exemptive authority with regard to certain provisions of the Exchange Act. Included in Exchange Act Section 12(h) is the authority to create appropriate exemptions from the Exchange Act registration requirements. Under Exchange Act Section 12(h), the Commission may exempt a class of securities by rules and regulations or by order if it “finds, by reason of the number of public investors, amount of trading interest in the securities, the number and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors.” Exchange Act Section 12(h) [15 U.S.C. 78j(h)].

²⁴ We believe that the exemption is consistent with the exemption provided for other employee benefit plans in Exchange Act Rule 12h-1, which is not available for stock option plans, the compensatory employee stock options issued pursuant to such plans, or the securities issued on exercise of such compensatory employee stock options. We believe that the characteristics of many employee benefit plans, which are by their own terms limited to employees, not available to the general public, and subject to transfer restrictions, obviate the need for applicability of all the rules and regulations aimed at public trading markets. In addition, because many of the conditions in the exemption refer to certain Securities Act Rule 701 definitions and requirements, we believe that the exemption from Exchange Act Section 12(g) registration will allow non-reporting issuers to continue to rely on Securities Act Rule 701 in offering and selling compensatory employee stock options and the shares issued on exercise of those options.

compensatory circumstances of the securities issuance and the restrictions on transferability of the compensatory employee stock options. As such, we believe that the exemption is in the public interest, in that it would clarify and routinize the basis for an exemption from Exchange Act Section 12(g) registration for compensatory employee stock options so private, non-reporting issuers would be able to continue to use compensatory employee stock options and would provide appropriate investor protections for optionholders.

1. Eligible Issuers

The amendment we are adopting today will provide an exemption from Exchange Act Section 12(g) registration for compensatory employee stock options of the following types of issuers:

- Issuers that do not have a class of securities registered under Exchange Act Section 12; and
- Issuers that are not subject to the reporting requirements of Exchange Act Section 15(d).²⁵

The exemption will be available only to those issuers that are not required to report under the Exchange Act. As such, the exemption will terminate once the issuer becomes subject to the reporting requirements of the Exchange Act. The exemption also will terminate if the issuer no longer satisfies the conditions to the exemption.²⁶

²⁵ Under Exchange Act Section 15(d), an issuer's "duty to file [reports under Section 15(d) is] automatically suspended if and so long as any issue of securities of such issuer is registered pursuant to section 12 of this title." [15 U.S.C. 78o(d)].

²⁶ The exemption under Exchange Act Section 12 will allow issuers 120 calendar days to register the class of options once an issuer no longer is able to rely on the exemption. Currently, the no-action letter relief terminates once an issuer becomes subject to the Exchange Act reporting requirements. See, e.g., no-action letter to VG Holding, note 7 supra. Moreover, the exemption will not be

2. Eligible Compensatory Employee Stock Options

The exemption for compensatory employee stock options will:

- Apply only to compensatory employee stock options that are issued under a written compensatory stock option plan²⁷ that is limited to employees, directors, consultants, and advisors of the issuer, its parents, or majority-owned subsidiaries of the issuer or its parents;²⁸
- Apply to all compensatory employee stock options issued under all written compensatory stock option plans on a combined basis where the securities underlying the compensatory employee stock options are of the same class of securities of the issuer, with the exemptive conditions applying to the compensatory employee stock options issued under each option plan; and
- Not extend to any class of securities received or to be received on exercise of the compensatory employee stock options.

available if the issuer was required, but failed, to register another class of equity security under the Exchange Act.

²⁷ Securities Act Rule 701 is available only for offers and sales of compensatory employee stock options and the shares issuable upon exercise of those options that are issued under written compensatory employee benefit plans of an issuer, its parents, or majority-owned subsidiaries of the issuer or its parents. See Securities Act Rule 701(c) [17 CFR 230.701(c)]. Thus, the requirement that the options be issued under written compensatory stock option plans will not impose a new obligation on issuers relying on Securities Act Rule 701 in offering and selling compensatory employee stock options or the shares issued on exercise of those options.

²⁸ The exemption for the compensatory employee stock options will not extend to other rights issued in connection with the compensatory employee stock options, such as stock appreciation rights. Any such other rights will be evaluated separately for purposes of Exchange Act Section 12(g) registration. Some commenters had requested that the exemption apply to all compensation arrangements involving securities, including restricted stock units, stock appreciation rights, and other rights or securities. See letters from ABA and Freescale. Consistent with the scope of the staff no-action letters granting Section 12(g) registration relief for compensatory employee stock options, at this time we believe the exemption should address only compensatory employee stock options. We, therefore, are not expanding the scope of the exemption beyond compensatory employee stock options.

The exemption covers all compensatory employee stock options meeting the conditions of the exemption, even if the compensatory employee stock options are issued under separate written option plans of the issuer, its parents, or majority-owned subsidiaries of the issuer or its parents.²⁹ For the purpose of the exemption, the compensatory employee stock options will be considered to belong to the same class of equity security of the issuer if the same class of securities of the issuer will be issuable on exercise of the compensatory employee stock options.³⁰ While one commenter requested that we allow companies to determine whether a particular group of compensatory employee stock options was the same class as other compensatory employee stock options for purposes of determining whether it had met the 500 holder threshold,³¹ we are adopting the exemption as proposed in this regard.³² We believe that, solely for purposes of determining whether the Rule 12h-1 exemption is available, it is important to establish uniformity in evaluating whether there are 500 or more holders of compensatory employee stock options and so that issuers appropriately analyze when Exchange Act Section 12(g) applies to their compensatory employee stock options.³³

²⁹ In response to comment (see letter from ABA), we have clarified that the options may be granted under plans of the issuer, its parents, and majority-owned subsidiaries of the issuer or its parents.

³⁰ See Exchange Act Section 12(g)(5) [15 U.S.C. 78l(g)(5)].

³¹ See letter from ABA.

³² One commenter suggested that the class of options should only include those options issued after the effective date of the exemption that satisfied the conditions of the exemption. See letter from Drinker. We are not adopting such a provision. Under the Exchange Act, the class of equity security is not determined based on when the securities are issued. The exemption provides that the class of compensatory employee stock options for purposes of the exemption includes all compensatory employee stock options on the same class of the issuer's securities regardless of whether the plan is a plan of the issuer, its parents, or majority-owned subsidiaries of the issuer or its parents. No distinction is made in the exemption as to when those options are issued.

³³ This provision will not affect the separate class analysis under Exchange Act Section 12(g)(5) for other purposes.

The exemption, as adopted, applies to the compensatory employee stock options only and not to the securities issued (or to be issued) on exercise of the compensatory employee stock options. Thus, the issuer will have to apply the registration requirements of Exchange Act Section 12 to the class of equity security underlying the compensatory employee stock options without regard to the exemption.³⁴

3. Eligible Option Plan Participants

The exemption is available only where the class of persons eligible to receive compensatory employee stock options under the stock option plans is limited to those persons described in the exemption. These eligible optionholders are the same as those participants permitted under Securities Act Rule 701 and include.³⁵

- Employees of the issuer, its parents, or majority-owned, direct or indirect, subsidiaries of the issuer or its parents;
- Directors of the issuer, its parents, or majority-owned, direct or indirect, subsidiaries of the issuer or its parents; and
- Consultants and advisors of the issuer, its parents, or majority-owned, direct or indirect, subsidiaries of the issuer or its parents.

As adopted, the exemption is limited to those situations where compensatory employee stock options may be held only by those persons who are permitted to hold or be granted compensatory employee stock options under Securities Act Rule 701 and their

³⁴ For example, if an issuer had more than \$10 million in assets and 500 or more holders of a class of equity security underlying the compensatory employee stock options as of the end of its fiscal year, it would have to register under Exchange Act Section 12 that class of equity security.

³⁵ See the discussion at note 22 supra.

permitted transferees.³⁶ We believe that the experience of issuers and their counsels with Securities Act Rule 701 will ease compliance with and limit uncertainty regarding the exemption.³⁷

Just as Securities Act Rule 701 was designed specifically not to be available for capital-raising transactions, the exemption will apply only to employee stock options issued for compensatory purposes. The restrictions on the eligible participants in the stock option plans are intended to assure that the exemption is limited to employee stock options issued solely for compensatory purposes.³⁸

4. Option Terms

a. Compensatory Employee Stock Option Transferability Restrictions

The exemption is available only where there are certain restrictions on the transferability by an optionholder of those options and, prior to the exercise of the options, the shares issuable on exercise of those options.³⁹ Specifically, the exemption is available only if:

³⁶ In this regard, we note that this category of eligible optionholders is broader than the category of persons to whom employee benefit securities, including compensatory employee stock options, may be offered and sold by reporting issuers using a Form S-8 registration statement. See General Instruction A.1(a) to Form S-8. As we note below, the exemption for reporting issuers will allow eligible optionholders to satisfy the definitions contained in either Securities Act Rule 701 or Form S-8 because an issuer may grant options both prior to and after it becomes subject to the periodic reporting requirements of the Exchange Act.

³⁷ Some commenters were concerned that the terms of outstanding options may not contain all the restrictive provisions of the exemption. (See letters from Drinker and Ross). We believe that our elimination of the restrictions on holders of shares received on exercise of an option and the modification of the transferability conditions affecting optionholders should address these concerns.

³⁸ All option grants and exercises must, of course, comply with the requirements of the Securities Act.

³⁹ The exemption does not impose any limitations on the ability of current or former employees, directors, consultants, or advisors of an issuer to retain or exercise their compensatory employee stock options.

- The compensatory employee stock options and, prior to exercise, the shares to be received on exercise of those options cannot be transferred except, as permitted by the exemption:⁴⁰
 - to family members (as defined in Securities Act Rule 701) by gift or pursuant to domestic relations orders; and
 - on death or disability of the optionholder;⁴¹
- There can be no other permitted pledges, gifts, hypothecations, or other transfers of the compensatory employee stock options, or shares issuable on exercise of those options, prior to exercise, until the issuer becomes subject to the reporting requirements of the Exchange Act or is no longer relying on the exemption; provided that there may be:
 - transfers back to the issuer; or
 - transfers in connection with a change of control or other acquisition transactions involving the issuer if, following such transaction, the options no longer will be outstanding and the issuer no longer will be relying on the exemption;⁴² and

⁴⁰ The transferability restrictions are not intended to supersede other transferability restrictions imposed for other reasons, including under the Internal Revenue Code of 1986, as amended [26 U.S.C. 422(b)(5)].

⁴¹ These permitted transferees are intended to be the same as those permitted under Securities Act Rule 701(c) as well as executors or guardians of an optionholder on the death or disability of the optionholder. See note 22 supra.

⁴² After an issuer becomes subject to the reporting requirements of the Exchange Act, the issuer will be able to rely on the exemption for Exchange Act reporting issuers only if it becomes subject to Exchange Act reporting as a result of its Exchange Act Section 12 registration of a class of security or pursuant to Exchange Act Section 15(d).

- The compensatory employee stock options or the securities issuable upon exercise of those options cannot be the subject of a short position, a “put equivalent position”⁴³ or a “call equivalent position”⁴⁴ by the optionholder, prior to exercise, until the issuer becomes subject to the reporting requirements of the Exchange Act or is no longer relying on the exemption; provided that the options may be subject to repurchase rights of the issuer or the optionholder may participate in a change of control or other acquisition transaction involving the issuer.

As adopted, the conditions provide that, except with regard to the limited permitted transfers specified in the conditions, an optionholder 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.⁴⁵ For the exemption to be available, these transfer restrictions will have to apply to options outstanding at the time that the issuer is relying on the exemption.

⁴³ 17 CFR 240.16a-1(h). Rule 16a-1(h) defines a “put equivalent position” as a derivative security position that increases in value as the value of the underlying equity decreases, including, but not limited to, a long put option and a short call option position.

⁴⁴ 17 CFR 240.16a-1(b). Rule 16a-1(b) defines a “call equivalent position” as a derivative security position that increases in value as the value of the underlying equity increases, including, but not limited to, a long convertible security, a long call option, and a short put option position.

⁴⁵ The current no-action letters contain similar conditions on transferability of the options, although the rule as adopted clarifies the limitations on the ability of optionholders to engage in certain derivative transactions prior to exercise, such as restrictions on an optionholder from entering into a “put equivalent position” or “call equivalent position” until the issuer becomes subject to the reporting requirements of the Exchange Act, or is no longer relying on the exemption. See, e.g., no-action letter to VG Holding, note 7 supra. In addition, the amendment as adopted does not restrict holders of shares following exercise of compensatory employee stock options.

The restrictions on transfer of the compensatory employee stock options and the shares underlying those options, prior to exercise, are intended to limit the possibility for a trading market to develop for the compensatory employee stock options while the issuer is relying on the exemption. These restrictions also are intended to assure that an optionholder is not able to profit from the compensatory employee stock options or the securities to be received on exercise of those options (except from permitted payments or transfers as described in the exemption), until the issuer becomes subject to the reporting requirements of the Exchange Act or is no longer relying on the exemption.

In response to comments, we have modified the transferability condition to permit optionholders to receive compensation for their options from the issuer or arising from a change of control or other acquisition transaction after which the options no longer will be outstanding and the issuer no longer will be relying on the exemption.⁴⁶

Commenters also were concerned that a requirement for an issuer to repurchase the shares or options due to state law limitations on transfer restrictions could have adverse accounting consequences to companies.⁴⁷ As a result, we have modified the transferability conditions to eliminate a requirement for an issuer to repurchase options if an express prohibition on transfer of options is not permitted under applicable state law. Instead, the condition permits the issuer to provide that it may repurchase the options in the event of an impermissible transfer. Issuers also may provide that the options terminate in such an event. We note that compensatory employee stock option plans or written stock option agreements generally restrict the persons who may exercise the

⁴⁶ See letters from ABA, Ross, and Simpson.

⁴⁷ See letters from CAQ, D&T, E&Y, and KPMG.

options, so providing for a termination of an option in the event of an impermissible transfer would, in many cases, already be contemplated by the terms of the written stock option agreement or plan.

We proposed that the transferability restrictions apply to holders of shares issued on exercise of the options. In response to comments,⁴⁸ we have not adopted this condition of the exemption. We understand from commenters that private, non-reporting issuers normally already have shareholder agreements and other mechanisms to restrict the transfer of shares received on exercise of options prior to the time the issuer becomes subject to the reporting requirements of the Exchange Act or is involved in a change of control or other acquisition transaction involving the issuer.⁴⁹ We also understand that private, non-reporting issuers do not anticipate that optionholders will exercise their options prior to a liquidity event, such as an initial public offering or sale of the company, or prior to termination of the options.⁵⁰

We are not adopting as a condition to the exemption separate transferability restrictions on holders of the shares received on exercise of the compensatory employee stock options. While we acknowledged in the Proposing Release the existence of

⁴⁸ See letters from ABA, Drinker, Ross, and Simpson.

⁴⁹ See letters from ABA, Freescale, Ross, and Simpson.

⁵⁰ In expressing their views that the proposed transferability restrictions should not be expected to affect a private company's ability to value the compensatory employee stock options under Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123R (revised 2004) Share-Based Payment (FAS 123R), some commenters noted that in valuing employee stock options for purposes of FAS 123R, private, non-reporting issuers use an expected term assumption that does not anticipate early exercise of the options. See letters from CAQ, E&Y, and KPMG. These commenters noted that employees of non-public companies normally do not have an incentive to exercise a vested option early due to the lack of a market for the underlying shares. These commenters observed that non-public company employees typically hold their options until they have incentive to exercise such as at the end of their terms, termination of employment, or until a liquidity event, such as an initial public offering or sale of the company occurs.

company-imposed and securities law transferability restrictions, we are persuaded to modify the exemption in light of the additional concerns that commenters believed the proposed transferability restrictions would raise. In modifying the exemption, we have considered the treatment of compensatory employee stock options under Securities Act Rule 701 as restricted securities as defined in Securities Act Rule 144,⁵¹ the fact that optionholders typically do not exercise their options prior to their termination or a liquidity event and the fact that, if exercised, most private companies take steps to restrict transferability of shares received on exercise of compensatory employee stock options, so that there is a limited possibility of a market developing in the securities issued on exercise of immediately exercisable compensatory employee stock options. In addition, we have considered a commenter's view that imposing separate transferability restrictions on the holders of shares received on exercise of compensatory employee stock options may affect a company's decision to use stock options for compensatory purposes.⁵² We also note that the exemptions we are adopting today do not impact the continued potential applicability of Exchange Act Section 12(g) to the securities issued on exercise of the options.

We also are not adopting the proposed restriction on other shares of the same class of equity security as those underlying the options. We believe that this restriction is no longer necessary because we have not adopted transferability restrictions on holders of securities received on exercise of compensatory employee stock options. In addition, we have taken into account one commenter's concern that the transferability restrictions on

⁵¹ 17 CFR 230.144. See, e.g., Securities Act Rule 701(g).

⁵² See letter from ABA. See also, letter from Ross.

the optionholder with respect to shares of the same class as those issuable on exercise of the options would affect an optionholder's ability to dispose of other securities of the issuer that the optionholder owned.⁵³

As proposed, the exemption would have provided that there could be no market, process, or methodology that would permit optionholders, prior to exercise, to receive compensation or consideration for their options, the shares issuable on exercise of the options, or shares of the same class of equity security as those underlying those options. Commenters noted that generally there is no market for the securities underlying the options while the issuer is a private, non-reporting entity.⁵⁴ Commenters were concerned that optionholders should not be disadvantaged from receiving payments from an issuer or in connection with a change of control or other corporate transaction involving an issuer, either with respect to their options or shares of the issuer they already own.⁵⁵ In light of these comments, we do not believe the exemption should impair an optionholder's ability to participate in transactions involving the issuer's securities they already own and we do not believe the exemption should restrict an issuer or other shareholders from engaging in particular transactions due to the issuer's reliance on the exemption.

b. Permitted Exercisability of Compensatory Employee Stock Options

The exemption will not require that there be any restriction on the timing of the exercise of the compensatory employee stock options:

⁵³ See letter from Ross.

⁵⁴ See letters from ABA, Freescale, Ross, and Simpson.

⁵⁵ See letters from ABA, Freescale, Ross, and Simpson.

- by the optionholder (regardless of whether the optionholder continues to be an employee, director, consultant or advisor of the issuer);
- in the event of the death or disability of the optionholder, by the estate or guardian of the optionholder; or
- by a family member (as defined in Securities Act Rule 701) who acquired the options through a gift or domestic relations order.

5. Required Information

We are adopting the proposed requirement that the issuer provide information to optionholders with certain modifications. In response to comment, we are not adopting a requirement for issuers to provide information to holders of shares received on exercise of compensatory employee stock options after exercise or for issuers to provide optionholders access to their books and records.⁵⁶

As adopted, the information condition will require the issuer, for purposes of the exemption, to periodically provide the following information to optionholders:⁵⁷

- The same risk and financial information that would be required to be provided under Securities Act Rule 701 if securities sold in reliance on Securities Act Rule 701 in a 12-month period exceeded \$5 million (as such provision may be modified⁵⁸), with the optionholders being provided every six months required information, including financial statements that are not more than 180 days old.⁵⁹

⁵⁶ See letter from ABA.

⁵⁷ In response to comment (see letters from ABA and Ross), we are clarifying that the information conditions may commence once a company has 500 or more optionholders and may terminate once the company becomes subject to the reporting requirements of the Exchange Act or is no longer relying on the exemption.

⁵⁸ One commenter suggested that the exemption take into account changes in the dollar threshold in Securities Act Rule 701. See letter from ABA. The rule text, as proposed and adopted, refers

The hours and costs associated with preparation of notices, maintaining Internet sites, and preparation of information to be disclosed to optionholders for private, non-reporting issuers relying on the exemption from Exchange Act Section 12(g)⁸⁸ registration constitute cost burdens imposed by the collection of information. The exemption available to reporting issuers will not constitute new collections of information. The amendments will not affect existing collections of information.

The exemptions from Exchange Act Section 12(g) registration are being adopted pursuant to the Exchange Act. The information collection requirements related to the exemption for private, non-reporting issuers are a condition to reliance on the exemption. There is no mandatory retention period for the information disclosed and the information disclosed is not required to be filed with the Commission.

B. Summary of Collection of Information

Our amendments to Exchange Act Rule 12h-1 will provide an exemption for private, non-reporting issuers from Exchange Act Section 12(g) registration for compensatory employee stock options issued under employee stock option plans. The amendments also will provide an exemption from Exchange Act Section 12(g) registration for compensatory employee stock options of issuers that are subject to the periodic reporting requirements of the Exchange Act pursuant to Exchange Act Section 13 or Section 15(d).

The requirements regarding notice of information availability, Internet availability of information, and, for certain issuers, the preparation of information related to the

⁸⁷ 44 U.S.C. 3507(d) and 5 CFR 1320.11.

⁸⁸ 15 U.S.C. 78j(g).

