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## Commission Adopts Exemptions from Exchange Act Registration Requirements for Compensatory Employee Stock Options

On December 7, 2007, the U.S. Securities and Exchange Commission (the "Commission") adopted exemptions from the registration requirements of Section 12(g) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), for compensatory employee stock options. Release No. 34-56997. The exemptions, proposed on July 5, 2007, amend Rule 12h-1 under the Exchange Act and apply to stock options issued by both private companies (companies that do not have a class of securities registered under Section 12 of the Exchange Act and are not subject to the reporting requirements of Section 15(d) of the Exchange Act) and public companies. The exemptions are especially welcome for private companies that otherwise would be required to register employee stock options as a separate class of equity securities under the Exchange Act or to seek no-action relief or an exemptive order under Section 12(h) of the Exchange Act to avoid registration. For public companies, the exemptions do not change (although they provide an analytical foundation for) existing practice. The exemptions relate exclusively to registration requirements under the Exchange Act and do not alter the need for both public and private companies to ensure that their employee options are issued in compliance with the registration requirements of the Securities Act of 1933, as amended, or in reliance on an exemption from registration.

### Background

Section 12(g) of the Exchange Act requires companies with 500 or more holders of record of a class of equity securities and assets in excess of \$10 million at the end of its most recently ended fiscal year to register that class of securities, unless an exemption from registration is available. While participation interests issued under certain types of employee compensation plans (such as employee stock bonus, stock purchase, profit sharing, pension, retirement, incentive, thrift, savings or similar plans) are considered securities that are exempt from Section 12(g) registration, there has historically been no exemption for compensatory employee stock options.

The possible need to register employee options has posed particular challenges for private companies. The number of private, non-reporting companies granting (or wishing to grant) options to 500 or more service providers has grown in recent years due to a variety of developments. In the 1980s, private, non-reporting companies began using stock options to compensate many more individuals, including middle, and lower-level employees, directors, and consultants. Private equity firms that purchase public companies often inherit large workforces that were accustomed to receiving stock options as part of their incentive programs. Many foreign companies that are not publicly traded in the United States have grown their

U.S.-domestic operations and feel pressure to issue stock options to their U.S. personnel to ensure their compensation packages remain competitive. In any of these situations, a private, non-reporting company might find itself with a stock option program with 500 or more participants. While some private companies sought no-action relief from the registration requirements of Section 12(g) of the Exchange Act, others avoided granting employee stock options altogether due to the concern that their compensation decisions could trigger the registration requirements prior to engaging in public capital raising. The exemptions will enable private companies to design and implement stock option programs without triggering the registration and reporting requirements of the Exchange Act.

For public, reporting companies, the exemptions codify long-standing practice and provide certainty regarding the registration obligations under the Exchange Act with respect to employee options.

### Exemption for Private, Non-Reporting Companies

The first exemption applies to all private companies that do not have a class of securities registered under Section 12 of the Exchange Act and are not currently subject to the reporting requirements of Section 15(d) of the Exchange Act, including foreign private issuers whose shares have never been publicly

traded in the United States or who have deregistered by filing a Form 15. This exemption is available where -

- options are issued pursuant to a written compensatory stock option plan;
- the option holders are individuals who are eligible to participate in offerings under Rule 701 of the Securities Act of 1933, as amended (“Rule 701”) - - generally, the employees, directors, consultants, and advisors of the issuer, its parent, or their respective majority-owned subsidiaries;
- options, and prior to exercise, the underlying shares, may not be transferred, except to the option holder’s estate or guardian (in the event of his death or disability) or by gift or domestic relations order to a family member (as defined in Rule 701); and
- risk and financial information of the type that would be required to be provided under Rule 701 for offerings in excess of \$5 million in securities in a 12-month period is provided to option holders every six months either by physical or electronic delivery or by password-protected Internet site.

Foreign private issuers will need to be particularly attentive to the financial information requirement. Under Rule 701 as currently in effect, a company that prepares its financial statements in accordance with its home country’s standards must provide a U.S. GAAP reconciliation for the required Rule 701 financial information. In Release 33-8879 issued by the Commission on December 21, 2007, the Commission lifted this requirement as long as the issuer’s financial statements are prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB). While this development should facilitate Rule 701 compliance for many foreign private issuers, the Commission’s release gives rise to various interpretive issues whose resolution will determine the ultimate usefulness of the relief.

The Section 12(g) exemption enables private companies to protect their financial information by requiring option holders to agree to keep the information confidential. The issuer is not required to furnish the information to an option holder who does not agree to the confidentiality requirement.

The exemption covers all employee options meeting the conditions of the exemption where the securities underlying the options are of the same class, even if the options are issued under separate plan documents.

The exemption does not extend to the securities to be received on exercise of the options. Thus, the registration requirement will apply to a private company if, as a result of option exercises or otherwise, the Section 12(g) thresholds are exceeded.

The exemption applies only to options and does not extend to other instruments, such as stock appreciation rights or other equity-based compensatory arrangements. These other arrangements will be evaluated separately for purposes of meeting the registration requirements of Section 12(g) of the Exchange Act. In many cases, however, companies may be able to flexibly design other compensation elements within the framework of a stock option program and thereby remain within the scope of the exemption – for example, by including a “net share settlement” feature as a term of a stock option, rather than providing for a tandem stock-settled SAR.

Under amended Rule 12h-1, the transfer restrictions must be included in the plan document, the award agreement or the issuer’s corporate organizational documents. In addition, both the stock option and, prior to exercise, the underlying security may not be the subject of a short position, a put equivalent position, a call equivalent position or other similar pledge arrangement by the option holder until the issuer is no longer relying on the exemption. As a result, amended Rule 12h-1 limits certain estate or financial planning activities of the option holders prior to exercise; these limitations generally conform to the conditions set forth in the prior no-action letters granting relief from registration for stock options. Amended Rule 12h-1 does permit transfers of options from the option holder to the issuer, and transfers made in connection with a change of control or other transactions involving the issuer, but only if after the transaction the options no longer will be outstanding and the issuer no longer will be relying on the exemption.

If a private company becomes subject to the reporting requirements of the Exchange Act or no longer satisfies the conditions for the exemption, it will have 120 calendar days to register the class of options – unless the exemption for public companies applies.

### Exemption for Public, Reporting Companies

The second exemption applies to all public companies required to file periodic reports under Section 13 or Section 15(d) of the Exchange Act. This exemption is available where -

- options are issued pursuant to a written compensatory stock option plan; and
- eligible option holders are those individuals eligible to participate in offerings under Rule 701 or under Form S-8.

The exemption for reporting companies does not impose any additional information requirements and does not require that the company be current in its Exchange Act reporting.

Historically, few, if any, public companies registered their employee stock options under Section 12(g) of the Exchange Act, even if their option program included more than 500 participants. As the Commission recognized in July 2007 when it proposed the exemptions for employee options, registration would serve little purpose in these circumstances, as the option holders already have access to the issuer's publicly filed Exchange Act reports and the appropriate provisions of Sections 13, 14, and 16 of the Exchange Act. Nevertheless, until the recent approval of amended Rule 12h-1, there was no formal exemption from Section 12(g) for public company option programs with more than 500 participants. The Commission's recent action provides public companies with useful certainty concerning their obligations.

The public company exemption does not require that the class of securities underlying the stock options be registered under the Exchange Act, although this will generally be the case. The exemption remains available even if there is an "insignificant deviation" from the eligibility conditions of the exemption (that is, 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). While this provision may reassure public companies that inadvertent,

minor program failures will not trigger unexpected obligations, it does not present design opportunities, as the exemption is available only if the issuer makes a "good faith and reasonable" effort to comply in full.

If a public, reporting company becomes a private, non-reporting company due to the suspension or termination of its reporting obligations, it may rely on the exemption for stock options of private, non-reporting companies described above if it satisfies those conditions.

This possibility is helpful for foreign private issuers that are deregistering under Exchange Act Rule 12g3-2(e), which came into force in June 2007. Under this rule, a foreign private issuer that files a Form 15F to deregister a class of equity securities qualifies for the Rule 12g3-2(b) exemption automatically upon the effectiveness of termination of registration of that class. Prior to the amendment of Rule 12h-1, a technical issue had arisen as to whether a foreign private issuer that filed a Form 15F and had over 300 option holders in the United States at the end of its fiscal year might be obligated to re-register if amended Rule 12g3-2(b) were not available for the class of compensatory stock option. The amendments to Rule 12h-1 will permit a deregistering foreign private issuer with more than 300 option holders to remain deregistered, provided that the requirements applicable to employee stock options under amended Rule 12h-1 for private companies are satisfied.

#### Effective Date

The exemptions to the registration requirements of Section 12(g) of the Exchange Act are effective as of December 7, 2007.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations, if desired.

For more information on the topics covered in this memorandum, please contact:

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