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SEC Proposes New Exemptions From Exchange Act Registration for Compensatory Employee Stock Options

Companies that have yet to go public but that have issued, or would like to issue, stock options to a significant number of employees have for years been concerned about triggering Exchange Act registration before they are ready to go public. Public companies have typically focused on the Securities Act consequences of issuing stock options, but generally do not consider that they need to register the options under the Exchange Act. After having provided relief on an ad hoc basis through no-action letters, the SEC has now proposed for public comment amendments to Exchange Act Rule 12h-1 to provide relief for such non-reporting companies that issue options to 500 or more eligible participants under their option plans and to provide clarity for such reporting companies by establishing an express exemption that obviates the need for separate Exchange Act registration of options. The proposed amendments would:

- provide an exemption for compensatory employee stock options issued by private, non-reporting issuers under employee stock option plans; and
- provide an exemption for issuers that have registered under Exchange Act Section 12 the class of equity securities underlying the compensatory employee stock options from having to separately register the options.

“Compensatory employee stock options” are stock options issued to employees, directors, consultants, and advisors (to the extent permitted under Securities Act Rule 701).

Comments are due by September 10, 2007.

Proposed Exemption for Compensatory Employee Stock Options of Non-Reporting Issuers

Under the proposed amendments, non-reporting issuers would be eligible for an exemption from registration under the Exchange Act for compensatory employee stock options issued under a written compensatory stock option plan as long as (a) eligible option holders are limited to persons to whom offers and sales of securities under written compensatory benefit plans may be made in reliance on Securities Act Rule 701, (b) transferability of the compensatory stock options, the underlying equity securities received or receivable on exercise of the options, and equity securities of the same class as those underlying the options is restricted, and (c) certain risk and financial information is provided to holders of the options or equity securities received on

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exercise of the options that is of the type that would be required under Securities Act Rule 701 if securities sold in reliance on Securities Act Rule 701 exceeded \$5 million in any 12 month period.

Eligible Issuers

The proposed exemption would apply to compensatory employee stock options of “non-reporting issuers,” defined as issuers that do not have a class of securities registered under Exchange Act Section 12 and are not subject to the reporting requirements of Exchange Act Section 15(d). As proposed, an issuer that files Exchange Act reports voluntarily should be eligible for the exemption, because that issuer would not have an obligation under Exchange Act Section 15(d).

The proposed exemption would terminate once the issuer becomes subject to the reporting requirements of the Exchange Act and would allow the issuer 60 calendar days thereafter to register the class of options under the Exchange Act. As a result, a pre-IPO issuer relying on the exemption would become ineligible if it were to become subject to an obligation under Exchange Act Section 15(d) (e.g., as a result of a registered exchange offer following an offering of debt securities under Securities Act Rule 144A).

Eligible Compensatory Employee Stock Options

The proposed exemption would apply only to compensatory employee stock options that are issued under one or more written compensatory stock option plans that are limited to eligible option plan participants as described below. Compensatory employee stock options would be considered to belong to the same class of equity security if the same class of securities would be issuable on exercise of the options, even if issued under separate written compensatory stock option plans. This requirement is consistent with Securities Act Rule 701, which is available only for offers and sales of compensatory employee stock options and the equity securities issuable upon exercise of those options that are issued under written compensatory employee benefit plans of an issuer, its parents, or any majority-owned subsidiary of either the issuer or its parents.

The proposed exemption would not extend, however, to (a) the underlying equity securities issued (or to be issued) on exercise of the compensatory employee stock options or (b) other rights issued in connection with the compensatory employee stock options, such as stock appreciation rights. The issuer would have to comply with the registration requirements of Exchange Act Section 12 in respect of such underlying equity securities or rights.

Eligible Option Plan Participants

The proposed exemption would be available only where the class of persons eligible to receive compensatory employee stock options pursuant to the terms of the written compensatory stock option plans is limited to persons described in the exemption. These eligible option holders consist of persons to whom offers and sales of securities under written compensatory benefit plans may be made in reliance on Securities Act Rule 701 and include persons with the following relationships to the issuer, its parents, or majority-owned subsidiaries of either the issuer or its parents:

- 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.

These restrictions on eligible participants are intended to assure that such exemptions from registration under the Securities Act and Exchange Act, respectively, are only used for employee stock options issued solely for compensation purposes and not in any capital-raising transaction.

Option Terms

Transferability Restrictions on Options and Underlying Equity Securities

The proposed exemption would be available only where the following restrictions are imposed by the written compensatory stock option plan on the transferability by a holder of the compensatory employee stock options, the underlying equity securities received or receivable on exercise of the options, or equity securities of the same class as those underlying the options:

- the compensatory employee stock options and the underlying equity securities received or receivable on exercise of the options are not transferable except (a) to family members (as defined in Securities Act Rule 701) by gift or pursuant to domestic relations orders or (b) on death or disability of the option holder;
- holders of options or equity securities received on exercise of the options through a permitted transfer from the original holder, as described above, could not transfer those options or equity securities further;
- no other pledges, gifts, hypothecations, or other transfers of the compensatory employee stock options, the underlying equity securities received or receivable on exercise of the options, or equity securities of the same class as those underlying the options by the holder thereof could be permitted, other than transfers back to the issuer (or to affiliates of the issuer if the issuer is unable to repurchase the options or equity securities) until the issuer becomes subject to the reporting requirements of the Exchange Act;

- the compensatory employee stock options, the underlying equity securities received or receivable on exercise of the options, or equity securities of the same class as those underlying the options could not be the subject of a short position, a “put equivalent position,” or a “call equivalent position” by the holder thereof until the issuer becomes subject to the reporting requirements of the Exchange Act; and
- there must be no market or available process or methodology that would permit holders to receive any consideration or compensation for the compensatory employee stock options, the underlying equity securities received or receivable on exercise of the options, or equity securities of the same class as those underlying the options, except from permitted transfers to the issuer or its affiliates as described above, until the issuer becomes subject to the reporting requirements of the Exchange Act.

These proposed transfer restrictions are similar to those contained in the existing line of no-action letters and substantially consistent with transfer restrictions on stock options and the underlying equity securities under Securities Act Rule 701. Such restrictions are intended to limit the possibility for a trading market to develop for the compensatory employee stock options or the underlying equity securities received or receivable on exercise of the options while the issuer is relying on the proposed exemption and therefore not reporting under the Exchange Act. They are also intended to assure that a holder of the compensatory employee stock options or the underlying equity securities received or receivable on exercise of the options is not able to profit from those securities until the issuer becomes subject to the reporting requirements of the Exchange Act.

In the event an express prohibition on the transfer of compensatory employee stock options, the underlying equity securities received or receivable on exercise of the options, or equity securities of the same class as those underlying the options is not permitted under applicable state law, the proposed exemption would be available if the issuer retained the obligation, either directly or by assignment to an affiliate of the issuer, to repurchase such options or equity securities until the issuer becomes subject to the reporting requirements of the Exchange Act.

Permitted Exercisability of Compensatory Employee Stock Options

The proposed exemption would not require any restrictions on the timing of the exercise of the compensatory employee stock options (a) by the option holder (regardless of whether the option holder continues to be an employee, director, consultant, or advisor of the issuer); (b) in the event of the death or disability of the option holder, by the estate or guardian of the option holder; or (c) by a family member (as defined in Securities Act Rule 701) who acquired the options through a gift or domestic relations order.

Required Information

Securities Act Rule 701 requires that certain risk factor and financial information be provided to an option holder a reasonable period of time before the date of exercise of the compensatory employee stock options if securities sold in reliance on Securities Act Rule 701 exceed \$5 million in any consecutive 12-month period, including financial statements as of a date

no more than 180 days before the date of exercise of the compensatory employee stock options. The information requirement of the proposed exemption would be broader than those under Securities Act Rule 701 in the following ways:

- the issuer would be required to provide such information to holders of compensatory employee stock options or equity securities received on exercise of the options on an ongoing basis, including required financial statements that are never more than 180 days old;
- the issuer would be required to provide such information whether or not securities sold in reliance on Securities Act Rule 701 exceed \$5 million in any consecutive 12-month period; and
- the issuer would also be required to provide to holders of compensatory employee stock options or equity securities received on exercise of the options access to its books and records, including corporate governance documents, to the same extent that they are available to the issuer's other shareholders.

The proposed exemption would allow some flexibility in the means of providing the required information and the terms pursuant to which it is provided. The issuer would be required to provide the required information to holders of compensatory employee stock options or equity securities received on exercise of the options either by: (a) physical or electronic delivery (in compliance with the SEC's interpretations regarding electronic delivery of information) or (b) notice to such holders of the availability of the information on a password-protected Internet site and any password needed to access the information. In addition, issuers would be permitted to safeguard proprietary or confidential information that may be contained in the required information by conditioning the provision of the required information on an agreement by such holder to maintain the confidentiality of the information. If a holder of compensatory employee stock options or equity securities received on exercise of the options chooses not to enter into such a confidentiality agreement, the proposed exemption would permit the issuer to choose to not provide the information to such holder and instead allow the holder to inspect the required information at one of the issuer's offices.

This information requirement under the proposed exemption represents a departure from the requirement set forth in the existing line of no-action letters, wherein the SEC staff provided relief only where the issuer commits to providing essentially the same information and reports as if it were an Exchange Act reporting issuer. These more relaxed information requirements stem from the SEC's belief that experience with Securities Act Rule 701 and the combined conditions of the proposed exemption, including the eligibility and transferability provisions, alleviate the need for the level of information called for by prior no-action letters in the context of an on-going reporting exemption relating to compensatory employee stock options.

Issuer Obligation to Impose the Conditions to the Proposed Exemption

For the proposed exemption to be available, a non-reporting issuer would be required to include the limitations and conditions set forth above either in the written compensatory stock option plans or within the terms of the individual written stock option agreements. In addition, the

transferability restrictions on the equity securities received on exercise of the compensatory employee stock options would also be required to be included in the issuer's by-laws, certificate of incorporation, or a stock purchase or shareholder agreement between the issuer and the exercising holder of compensatory employee stock options or equity securities received on exercise of the options.

Proposed Exemption for Compensatory Employee Stock Options of Reporting Issuers

The proposed amendments would also provide a separate exemption for compensatory employee stock options of reporting issuers that have registered under Exchange Act Section 12 the class of securities underlying the compensatory stock options. Most reporting issuers currently do not register compensatory stock options under Exchange Act Section 12(g) when the underlying securities are registered under the Exchange Act and the sale of the options and the equity securities issuable on exercise of the options are registered under the Securities Act on Form S-8. Because, in the SEC's view, public companies may be "unclear" as to the need to register compensatory employee stock options under the Exchange Act in these circumstances, the SEC believes that the proposed exemption will provide important guidance regarding, and an appropriate exemption to eligible issuers from, the Exchange Act registration requirements for compensatory stock options.

Eligible Issuers

The proposed exemption would apply to compensatory employee stock options of issuers that have registered under Exchange Act Section 12 the class of underlying equity securities that is issuable on the exercise of the compensatory employee stock options. Such registration under the Exchange Act Section 12 gives rise to a requirement to file reports under Exchange Act Section 13 and therefore, in the SEC's view, provides appropriate information to the public, including holders of compensatory employee stock options and the underlying equity securities received or receivable on exercise of the options. The proposed exemption would not be available to an issuer that is required to file Exchange Act reports solely pursuant to Exchange Act Section 15(d).

Eligible Compensatory Employee Stock Options

Consistent with the proposed exemption for non-reporting issuers, the proposed exemption for reporting issuers would apply only to compensatory employee stock options that are issued under one or more written compensatory stock option plans that are limited to eligible option plan participants as described below. Compensatory employee stock options would be considered to belong to the same class of equity security if the same class of securities would be issuable on exercise of the options, even if issued under separate written compensatory stock option plans.

Eligible Option Plan Participants

Consistent with the proposed exemption for non-reporting issuers, the proposed exemption for reporting issuers would be available only where the class of persons eligible to receive compensatory employee stock options pursuant to the terms of the written compensatory

stock option plans is limited to persons to whom offers and sales of securities under written compensatory benefit plans may be made in reliance on Securities Act Rule 701.

Required Information

The proposed exemption for reporting issuers would not include any information requirements, other than those arising from registration under Exchange Act Section 12 of the class of underlying equity securities that is issuable on the exercise of the compensatory employee stock options. In addition, the proposed exemption would not be conditioned on the issuer being current in its Exchange Act reporting. While the proposed exemption would apply to the registration of compensatory employee stock options as a separate class of equity security, the protections of Exchange Act Sections 13(e) and 14(e) would continue to apply to offers for those compensatory employee stock options. The requirements of Exchange Act Sections 16, 13(d), and 13(g) with respect to the underlying equity securities would continue to apply to the compensatory employee stock options that are exercisable for Exchange Act Section 12 registered securities.

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This memorandum is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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