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17 CFR Part 240

Exemption of Compensatory Employee Stock Options From Registration Under Section 12(g) of the Securities Exchange Act of 1934; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34–56010; International Series Release No. 1303; File No. S7–14–07]

RIN 3235–AJ91

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: Proposed rule.

SUMMARY: The Commission is proposing two exemptions from the registration requirements of the Securities Exchange Act of 1934 for compensatory employee stock options. The first exemption would be available to issuers that are not required to file periodic reports under the Exchange Act. The proposed exemption would apply only to the issuer's compensatory employee stock options and would not extend to the class of securities underlying those options. The second exemption would be available to issuers that are required to file those reports because they have registered under Exchange Act Section 12 the class of securities underlying the compensatory employee stock options.

DATES: Comments must be received on or before September 10, 2007.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's *Internet comment form (http://www.sec.gov/rules/proposed.shtml)*; or
- Send an e-mail to *rule-comments@sec.gov*. Please include File Number S7–14–07 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–14–07. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site *http://www.sec.gov/rules/proposed.shtml*. Comments also are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

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 proposing amendments to rule 12h–1[1] under the Securities Exchange Act of 1934.[2]

I. Introduction and Background

A. Introduction

In the 1980s, private, non-reporting issuers began using compensatory employee stock options[3] to compensate a broader range of employees, including executive, middle, and lower-level employees, directors, and consultants.[4] Compensatory employee stock options provide a method to use non-cash compensation to attract, retain, and motivate company employees, directors, and consultants.[5] Since the 1990s, a number of private, non-reporting issuers have granted compensatory employee stock options to 500 or more employees, directors, and consultants.[6]

Under Section 12(g)[7] of the Exchange Act, 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.[8] Stock options, including stock options issued to employees under stock option plans, are a separate class of equity security for purposes of the Exchange Act.[9] 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,[10] currently there is no

[1] 17 CFR 240.12h–1.

[2] 15 U.S.C. 78a *et seq.*

[3] Throughout this release, we use the term ''compensatory employee stock options'' to refer to stock options issued to employees, directors, consultants, and advisors (to the extent permitted under Securities Act Rule 701 [17 CFR 230.701]).

[4] 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 to only 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/abstracts=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).

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(d) [17 CFR 230.701(d)]; *Rule 701 Exempt Offerings Pursuant to Compensatory Arrangements*, Release No. 33–7645, 64 FR 11095 (March 8, 1999) (''Rule 701 Release''); *See also Compensatory Benefit Plans and Contracts*, Release No. 33–6768, 53 FR 12918 (April 14, 1988).

[5] *See* Hand Paper, note 4 *supra*.

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

[7] 15 U.S.C. 78*l*(g).

[8] 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 (April 13, 1982)], from $3 million to $5 million in 1986 [*Reporting by Small Issuers*, Release No. 34–23406 (July 8, 1986)], and from $5 million to $10 million in 1996 [*Relief from Reporting by Small Issuers*, Release No. 34–37157 (May 1, 1996)].

[9] Exchange Act Section 3(a)(11) [15 U.S.C. 78c(11)] defines equity security to include any right to purchase a security (such as options) and Exchange Act Rule 3a–11 [17 CFR 240.3a–11] explicitly includes options in the definition of equity security for purposes of Exchange Act Sections 12(g) and 16 [15 U.S.C. 78*l*(g) and 78p]. Exchange Act Section 12(g)(5) [15 U.S.C. 78*l*(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.''

[10] 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.

exemption for compensatory employee stock options.

We are proposing 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. We also are proposing an exemption from Exchange Act Section 12(g) registration for compensatory employee stock options of issuers that have registered under Exchange Act Section 12 the class of equity security underlying those options.

B. Overview of Applicable Exchange Act Provisions

The addition of Section 12(g) to the Exchange Act 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.'' [11] Further, Section 12(g) extended the disclosure and other Exchange Act safeguards to unlisted securities as a means to prevent fraud.[12] The Commission has noted that the registration requirement of Section 12(g) was aimed at issuers that had ''sufficiently active trading markets and public interest and consequently were in need of mandatory disclosure to ensure the protection of investors.'' [13]

Exchange Act Section 12(h) [14] provides the Commission with 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 exemptive 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.'' [15]

C. Historical Treatment of Compensatory Employee Stock Options Under Exchange Act Section 12(g)

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.[16] Since 1992, the Division has provided relief through no-action letters [17] to these private issuers when specified conditions were present.

Before 2001, the Division's no-action relief in this area was conditioned on, among other things, the options terminating at the time employment terminated. Further, that relief was conditioned on the compensatory employee stock options not being exercisable until after either the issuer's initial public offering or the time at which the issuer was no longer relying on the relief.[18] Beginning in 2001, the Division announced modified conditions to registration relief for compensatory employee stock options of private, non-reporting issuers that, due to market conditions, were delayed in their plans to go public.[19] Because the Division's no-action relief applies only to the private, non-reporting issuer's compensatory employee stock options, once that issuer has 500 or more holders of record of any other class of equity security (including, for example, common stock outstanding as a result of stock issuances, including option exercises), it would be required to register that other class of equity security under Exchange Act Section 12(g).

The Division's no-action letters providing Exchange Act Section 12(g) registration relief to private, non-reporting issuers currently include the following parameters:[20]

Scope of Relief

- The relief is limited solely to compensatory employee stock options granted under stock option plans; and
- No security appreciation rights or other rights may be issued in connection with the compensatory employee stock options.

Eligible Participants

- The compensatory employee stock options may be issued to a broad class of participants comprised only of employees, directors, and consultants (to the extent permitted under Securities Act Rule 701) of the issuer, its parents, or of majority-owned, direct or indirect, subsidiaries of the issuer or its parents.

Exercisability

- The exercisability of the compensatory employee stock options need not be limited while the optionholder is an employee, director, or consultant; however, if the compensatory employee stock options are not exercisable, there are modified information conditions.

Transferability and Ownership Restrictions

- There may be no means through which optionholders may receive compensation or consideration for the compensatory employee stock options (or the securities to be received on exercise of the compensatory employee stock options) before exercise; [21]
- The compensatory employee stock options must remain non-transferable in most cases, but the compensatory employee stock options may transfer on death or disability of the optionholder or to family members (as defined in Securities Act Rule 701) by gift or pursuant to domestic relations orders. These permitted transferees are not allowed to further transfer compensatory employee stock options. There may be no other pledging,

[11] 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.

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

[13] *Reporting by Small Issuers*, Release No. 34–23407 (July 8, 1986).

[14] 15 U.S.C. 78*l*(h).

[15] Exchange Act Section 12(h) [15 U.S.C. 78*l*(h)].

[16] 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].

[17] For the conditions necessary to receive relief under these letters and orders *see*, for example, the no-action letter to Mitchell International, note 6 *supra* (for the pre-2001 relief) and the no-action letters to AMIS Holdings, note 6 *supra*; ISE Labs, Inc. (available June 2, 2003); Jazz Semiconductor, Inc. (available Nov. 21, 2005) (''Jazz Semiconductor''); and VG Holding, note 6 *supra* (for the modified relief beginning in 2001).

[18] *See e.g.*, no-action letters to Kinko's, Inc., note 6 *supra*; General Roofing Services, Inc. (available April 5, 2000); and Mitchell International, note 6 *supra*.

[19] *See* Division of Corporation Finance, Current Issues and Rulemaking Outline Quarterly Update (March 31, 2001).

[20] Following the announcement of the modified conditions to relief in 2001, issuers were still able to request relief under the former conditions. Since 2002, however, issuers have received relief based on the modified factors only. *See e.g.*, no-action letters to Jazz Semiconductor, note 17 *supra*; Network General Corporation (available May 22, 2006); Avago Technologies Limited (available Oct. 6, 2006); and VG Holding, note 6 *supra*. Our discussion regarding the current conditions to relief under the no-action letters refers only to the modified conditions set forth in the most recently issued no-action letters.

[21] This would not include payments received on exercise by an issuer or its affiliates of a repurchase right or obligation with regard to the options or the shares received on exercise of the options. *See e.g.*, no-action letter to VG Holding, note 6 *supra*.

hypothecation or donative transfer of compensatory employee stock options or the securities underlying the options;

• The securities received on exercise of the compensatory employee stock options may not be transferable, except back to the issuer (or to affiliates of the issuer if the issuer is unable to repurchase the shares), to family members under Rule 701 by gift or pursuant to domestic relations orders, or in the event of death or disability. These permitted transferees are not allowed to further transfer these securities. There may be no other pledging, hypothecation or donative transfer of these securities; and

• The ability of former employees to retain and exercise their vested compensatory employee stock options for a period of time following termination of employment need not be limited.

Information Requirements

• The issuer must provide optionholders and holders of shares received on exercise of compensatory employee stock options with essentially the same Exchange Act registration statement, annual report, and quarterly report information they would receive if the issuer registered the class of securities under Exchange Act Section 12, including audited annual financial statements (prepared in accordance with generally accepted accounting principles (''GAAP'')) and unaudited quarterly financial information, with the following specific conditions:

—The registration statement-type document must be delivered promptly after the issuer receives no-action relief;

—The annual report must be delivered within 90 days after the issuer's fiscal year end; [22]

—The quarterly reports must be delivered within 45 days after the end of the issuer's fiscal quarter; [23]

—The issuer may condition delivery of the information to an optionholder on the optionholder signing an appropriate confidentiality agreement but it must make the information available for examination at the issuer's offices by optionholders and holders of shares received on exercise of options unwilling to enter into confidentiality agreements;

—The issuer must provide certifications similar to those required of reporting issuers; [24] and

—The issuer must provide specified information relating to option vesting and changes in the stock option plan.[25]

D. Recommendation of the Advisory Committee on Smaller Public Companies

The Advisory Committee on Smaller Public Companies, in its Final Report, recommended that the Commission provide Exchange Act Section 12(g) registration relief for compensatory employee stock options.[26] In this regard, the Advisory Committee stated:

> [H]olders of employee stock options received in compensatory transactions are less likely to require the full protections afforded under the registration requirements of the federal securities laws. Therefore, we believe that such stock options should not be a factor in determining the point an issuer becomes subject to the burdens of a reporting company under the Exchange Act.[27]

E. Overview of the Proposed Exemptions

We believe that it is appropriate at this time to propose 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.[28] Given the differences between issuers that are required to file 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 propose separate exemptions for these different types of issuers.

1. Exemption for Issuers That Are Not Exchange Act Reporting Issuers

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.[29] Based on the factors identified in Exchange Act Section 12(h), we believe that it is appropriate to provide an exemption from Exchange Act Section 12(g) registration to a specified class of compensatory employee stock options.[30] We believe that the conditions to the proposed 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 compensatory circumstances of the securities issuance

[22] Since 2006, the time period to deliver the annual report and the quarterly report was shortened to 90 days and 45 days, respectively, from the 120 days for the annual report and 60 days for the quarterly report that was allowed in the earlier no-action letters relying on the modified conditions. *See* no-action letters to VG Holding, note 6 *supra* and AMIS Holdings, note 6 *supra*.

[23] *Id*.

[24] The certification condition requires that the issuer's chief executive officer and chief financial officer include a certification as required by the first three paragraphs of the certification required under Item 601(b)(31) of Regulation S–K [17 CFR 229.601(b)(31)]. *See e.g.*, no-action letter to VG Holding, note 6 *supra*.

[25] *See e.g.*, no-action letter to VG Holding, note 6 *supra*.

[26] *Final Report of the Advisory Committee on Smaller Public Companies to the Securities and Exchange Commission,* April 23, 2006 (''Final Report of the Advisory Committee'').

[27] *Id* at p. 87.

[28] The proposed exemptions would allow compensatory employee stock options to be held only by those persons described in Securities Act Rule 701(c) [17 CFR 230.701(c)]. 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 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. As we note, the proposed amendments use the term ''those persons described in Rule 701(c)'' to refer to these permitted holders. 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).

[29] While we agree that an exemption from Exchange Act Section 12(g) registration for compensatory employee stock options is appropriate, in this regard, we do not agree with the Advisory Committee statement that holders of employee stock options received in compensatory transactions do not require the full protections afforded under the registration requirements of the federal securities laws.

[30] We believe that our proposal 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 proposed conditions refer to certain Securities Act Rule 701 definitions and requirements, we believe that the proposed 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.

and the restrictions on transferability of the compensatory employee stock options and shares received on exercise of those options. As such, we are proposing to amend Exchange Act Rule 12h–1 to provide an exemption from Exchange Act Section 12(g) registration for compensatory employee stock options issued under written compensatory stock option plans of an issuer that does not have a class of securities registered under Exchange Act Section 12 and is not subject to the reporting requirements of Exchange Act Section 15(d), where the following conditions are present: [31]

- Eligible optionholders are limited to employees, directors, consultants, and advisors of the issuer;
- Transferability by optionholders and holders of shares received on exercise of the options of compensatory employee stock options, shares received, or to be received, on exercise of those options, and shares of the same class as those underlying those options is restricted; and
- Risk and financial information is provided to optionholders and holders of shares received on exercise of those options that is of the type that would be required under Rule 701 if securities sold in reliance on Rule 701 exceeded $5 million in a 12-month period.[32]

The proposed exemption would apply only to a private, non-reporting issuer's compensatory employee stock options and would not extend to the class of securities underlying those options.[33]

The proposed restrictions on the type of issuer eligible to rely on the exemption, the limitation on who may be granted and hold the compensatory employee stock options, the transferability restrictions, and the limitation of the exemption to the compensatory employee stock options are intended to assure that there is no trading in the options or shares received on exercise of the options and that there are no public investors in the compensatory employee stock options that need the full range of protections that Exchange Act registration and reporting afford. In light of the circumstances under which private, non-reporting issuers issue compensatory employee stock options, the terms of those options, and the information provision requirements of the proposed exemption, we believe that the proposed amended rule contains appropriate conditions to an exemption of such compensatory employee stock options of private, non-reporting issuers from registration under Exchange Act Section 12(g). As such, we believe that the proposed 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 issue compensatory employee stock options and would provide appropriate investor protections for optionholders and holders of shares received on exercise of the options.

2. Exemption for Exchange Act Reporting Issuers

We are proposing to amend Exchange Act Rule 12h–1 to provide an exemption for compensatory employee stock options of issuers that are required to file reports under the Exchange Act because they have registered under Exchange Act Section 12 the class of equity security underlying those options. The proposed exemption would be available only where the options were issued pursuant to a written compensatory stock option plan and the class of persons eligible to receive or hold the options is limited appropriately. We believe that the proposed exemption of compensatory employee stock options from Exchange Act registration is appropriate for purposes of investor protection and the public interest because the optionholders would have access to the issuer's publicly filed Exchange Act reports and the appropriate provisions of Exchange Act Sections 13, 14, and 16 [34] would apply to the compensatory employee stock options and the securities issuable on exercise of the compensatory employee stock options.

II. Discussion of Proposals

We are proposing two amendments to Exchange Act Rule 12h–1. These amendments would:

- 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 issued by issuers that have registered under Exchange Act Section 12 the class of equity security underlying the compensatory employee stock options.

A. Proposed 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 for compensatory employee stock options of issuers that are not required to file reports under the Exchange Act. The availability of this proposed exemption would be subject to specified limitations, including limitations concerning permitted optionholders, transferability and provision of information.

1. Eligible Issuers

The proposed amendment would 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).[35]

The proposed exemption is intended to be available only to those issuers that are not reporting under the Exchange Act. As such, the proposed exemption would terminate once the issuer became subject to the reporting requirements of the Exchange Act.[36]

[31] The conditions build on and modify the current conditions to relief in the no-action requests discussed above. For example, the transferability restrictions in the proposed exemption are more clearly defined; there is no proposed restriction on the exercisability of the compensatory employee stock options; and the level of disclosure required to be provided to optionholders and holders of shares received on exercise of those options is the same level of information that private, non-reporting issuers relying on Securities Act Rule 701 for the offers and sales of those options and securities may be required to provide, rather than the level of information an issuer with public shareholders is required to provide. *See* the discussion under ''Proposed Exemption For Compensatory Employee Stock Options of Issuers That Are Not Exchange Act Reporting Issuers,'' below.

[32] *See* the discussion under ''Required Information,'' below.

[33] A private, non-reporting issuer would 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 proposed exemption. For the class of equity security underlying the options, for which there could be public shareholders, no transferability restrictions, and trading interest, we do not believe a Section 12 registration exemption would be appropriate.

[34] 15 U.S.C. 78m, 78n, and 78p.

[35] Under Section 15(d) of the Exchange Act, 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. 780(d)].

[36] The proposed exemption under Exchange Act Section 12 would allow issuers 60 calendar days to register the class of options once an issuer was no longer able to rely on the proposed exemption. Currently, the no-action letter relief terminates once an issuer becomes subject to the Exchange Act

Continued

Request for Comment

• Should the proposed exemption be available to any private, non-reporting issuer? If not, which categories of non-reporting issuers should be ineligible for the exemption?

• Should the proposed exemption be available to those issuers that file Exchange Act reports and, thus, hold themselves out as Exchange Act reporting issuers, but who have neither a class of securities registered under Exchange Act Section 12 nor an existing reporting obligation under Exchange Act Section 15(d) (also known as ''voluntary filers'')? Should ''voluntary filers'' be treated differently under the proposed exemption if they do not have any public shareholders of any class of their equity securities?

2. Eligible Compensatory Employee Stock Options

The proposed exemption for compensatory employee stock options would:

• Apply only to compensatory employee stock options that are issued under a written compensatory stock option plan [37] that is limited to employees, directors, consultants, and advisors of the issuer; [38]

• Apply to all compensatory employee stock options issued under all of the issuer's 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, with the proposed 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.

The proposed exemption would cover all compensatory employee stock options of an issuer meeting the conditions of the exemption, even if the compensatory employee stock options were issued under separate written option plans. For this purpose, the 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 compensatory employee stock options.[39]

The proposed exemption would apply 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 would 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 proposed exemption.[40]

Request for Comment

• Should the exemption cover all compensatory employee stock options issued under all employee stock option plans of a private, non-reporting issuer?

• Are there employee stock option plans that are not written that should be included? If so, what types of unwritten plans should be included and why?

• Are there employee stock options issued under written stock option contracts, other than written stock option plans, that should be included? If so, what types of written stock option contracts should be included and why?

• We have proposed to provide that the exemption would apply to all of the issuer's option plans on a combined basis where the securities underlying the compensatory employee stock options are of the same class of securities, while the options may be held by employees, directors, consultants, or advisors of an issuer, its parents, or majority-owned subsidiaries of the issuer or its parents. Should the class of options covered by the proposed exemption include only options issued by the issuer under its written compensatory plans or should the class of options covered by the proposed exemption also include options on the issuer's securities that are issued under written compensatory plans of the issuer's parent, its majority-owned subsidiaries or majority-owned subsidiaries of the issuer? Please explain.

3. Eligible Option Plan Participants

The proposed exemption would be 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 would be the same as those participants permitted under Rule 701 and would include: [41]

• 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.

We have proposed that the exemption be 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. We believe that the experience of issuers and their counsels with Rule 701 will ease compliance with and limit uncertainty regarding the exemption.[42]

Just as Securities Act Rule 701 was designed specifically not to be available for capital-raising transactions, the proposed exemption would 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 proposed exemption is limited to employee stock options issued solely for compensatory purposes.[43]

Request for Comment

• Should the proposal limit further the types of persons eligible to hold compensatory employee stock options for purposes of the exemption? If so, what types of persons should not be eligible?

• Is the use of the Securities Act Rule 701 definitions of eligible participants appropriate for purposes of the proposed exemption? If not, what definitions should be used to characterize the optionholders who

reporting requirements. *See e.g.*, no-action letter to VG Holding, note 6 *supra.*

[37] 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 proposed requirement that the options be issued under written compensatory stock option plans would not impose a new obligation on issuers relying on Securities Act Rule 701 in offering and selling its compensatory employee stock options or the shares issued on exercise of those options.

[38] The proposed exemption for the compensatory employee stock options would not extend to other rights issued in connection with the compensatory employee stock options, such as stock appreciation rights. Any such other rights would be evaluated separately for purposes of Exchange Act Section 12(g) registration.

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

[40] 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.

[41] *See* the discussion at note 28 *supra.*

[42] 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 1(a) to Form S–8 [17 CFR 239.16b].

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

have received the compensatory employee stock options solely for compensatory purposes and why should another definition be used?

• Would the proposed eligibility conditions affect an issuer's ability to rely on compensatory employee stock options to attract, retain, and motivate employees, directors, consultants, and advisors of the issuer?

4. Option Terms

a. Compensatory Employee Stock Option and Share Transferability Restrictions

The proposed exemption would be available only where there are certain restrictions on the transferability by an optionholder or holder of shares received on exercise of a compensatory employee stock option of those options, the shares issuable on exercise of those options, or shares of the same class of equity security as those underlying those options.[44] Specifically, the proposed exemption would be available only if:[45]

• The compensatory employee stock options and the shares received or to be received on exercise of those options could not be transferred except:[46]

—To family members (as defined in Rule 701) by gift or pursuant to domestic relations orders; or

—On death or disability of the optionholder;[47]

• Optionholders or holders of shares received on exercise of the compensatory employee stock options through a permitted transfer from the original holder could not transfer those options or shares further;

• There could be no other permitted pledges, gifts, hypothecations, or other transfers of the compensatory employee stock options, shares issued or issuable on exercise of those options, or shares of the same class of equity security as those underlying those options by the optionholder or holder of shares received on exercise of an option, other than transfers back to the issuer (or to affiliates of the issuer if the issuer is unable to repurchase those options or shares received on exercise of those options), until the issuer becomes subject to the reporting requirements of the Exchange Act;[48]

• The compensatory employee stock options, the securities issued or issuable upon exercise of those options, or shares of the same class of equity security as those underlying those options could not be the subject of a short position, a ''put equivalent position''[49] or a ''call equivalent position''[50] by the optionholder or holder of shares received on exercise of an option until the issuer becomes subject to the reporting requirements of the Exchange Act; and

• There could be no market or available process or methodology that would permit optionholders or holders of shares received on exercise of an option to receive any consideration or compensation for the options, the shares issuable on exercise of the options, or shares of the same class of equity security as those underlying the options, except from permitted transfers to the issuer or its affiliates as discussed above, until the issuer becomes subject to the reporting requirements of the Exchange Act.

Under the proposal, the exemption would not be available if optionholders and holders of shares received on exercise of compensatory employee stock options could enter into agreements, prior to or after the exercise of those options, that would allow those holders to monetize or receive compensation from or consideration for such compensatory employee stock options, the shares to be received upon exercise of those options, or shares of the same class of equity security as those underlying those options. Thus, the proposed conditions provide that, except with regard to the limited permitted transfers specified in the proposed conditions, an optionholder cannot be permitted to pledge, hypothecate, or otherwise transfer the compensatory employee stock options, the shares underlying those options, or shares of the same class of equity security as those 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. The proposed exemption would be conditioned on a similar restriction on the holders of shares received on exercise of the options.

The proposed restrictions on transfer of the compensatory employee stock options, the shares underlying those options, and shares of the same class of equity security as those underlying those options by an optionholder or holder of shares received on exercise of an option are intended to limit the possibility for a trading market to develop for the compensatory employee stock options or the securities issued on exercise of those options while the issuer is relying on the proposed exemption. These restrictions also are intended to assure that an optionholder or holder of shares received on exercise of an option is not able to profit from the compensatory employee stock options or the securities received or to be received on exercise of those options (except from permitted transfers to the issuer or its affiliates as discussed above), until the issuer becomes subject to the reporting requirements of the Exchange Act.

While, in most cases, the securities of private, non-reporting issuers that are issued on exercise of compensatory employee stock options are deemed to be restricted securities as defined in Securities Act Rule 144,[51] we believe that the proposed transferability restrictions are necessary to limit further the possibility of a market developing in the securities issued or issuable on exercise of immediately exercisable compensatory employee stock options while the issuer is not reporting under the Exchange Act. Thus, the proposed

[44] The proposed exemption would 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 current no-action letters do, however, contain certain limitations on retention of both vested and unvested compensatory employee stock options. *See e.g.*, no-action letter to VG Holding, note 6 *supra*.

[45] The current no-action letters contain similar conditions on transferability, although the proposed rule clarifies the limitations on the ability to engage in certain derivative transactions, such as restrictions on an optionholder or holder of shares received on exercise of options from entering into a ''put equivalent position'' or ''call equivalent position'' until the issuer become subject to the reporting requirements of the Exchange Act. *See e.g.*, no-action letter to VG Holding, note 6 *supra*.

[46] The proposed transferability restrictions would not 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)].

[47] These permitted transferees are intended to be the same as those permitted under Securities Act Rule 701(c). *See* note 28 *supra*.

[48] If an express prohibition on transfer 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 company, to repurchase the option or the shares issued on exercise of the options until the issuer becomes subject to the reporting requirements of the Exchange Act. This repurchase obligation would have to be contained in the stock option agreement pursuant to which the option is exercised, in a separate stockholders agreement, in the issuer's by-laws, or certificate of incorporation. *See* the discussion under ''Issuer Obligation to Impose the Conditions to the Proposed Exemption,'' below.

[49] 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.

[50] 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.

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

amendments would require that the issuer's securities received on exercise of compensatory employee stock options be restricted as to transfer until the issuer becomes subject to the reporting requirements of the Exchange Act.[52]

The proposed transfer restrictions for the compensatory employee stock options and the shares received or to be received on exercise of those options are consistent in most respects with the transfer restrictions on compensatory securities in Securities Act Rule 701.[53] In addition, we understand that private, non-reporting issuers generally restrict the transferability of shares received on exercise of compensatory employee stock options until the issuer becomes subject to the reporting requirements of the Exchange Act. As such, we believe that transferability restrictions should not impose additional constraints on such private, non-reporting issuers.

Request for Comment

- Should there be any other restrictions on the transferability by the optionholder or holder of shares received on exercise of the options of the compensatory employee stock options, the shares received on exercise of those options, or shares of the same class of equity security as those underlying those options prior to the issuer becoming subject to the reporting requirements of the Exchange Act?
- Should there be any other restrictions on the transferability of the securities received or to be received on exercise of the compensatory employee stock options or shares of the same class of equity security as the shares underlying those options?
- Should an optionholder be allowed to enter into agreements to transfer the shares to be received on exercise of the compensatory employee stock options or shares of the same class of equity security as the shares underlying those options prior to the exercise of those options while the issuer is relying on the exemption? If yes, why should an optionholder be able to enter into such arrangements and how would such arrangements affect whether an optionholder has received value for the compensatory employee stock options?
- Should there be restrictions on permitted transferees of compensatory employee stock options being able to further transfer such options? Should the permitted transferees be able to further transfer such options to other permitted transferees by gift, pursuant to domestic relations orders, or on death or disability? What types of other transfers, if any, should be permitted and why?
- Do the proposed restrictive provisions sufficiently cover hedging transactions by optionholders or holders of shares received on exercise of the options that would permit such persons to circumvent the proposed transferability conditions in the proposed exemption?
- Should the proposed exemption provide explicitly that the issuer may repurchase the compensatory employee stock options or shares received on exercise of those options if the issuer is unable to prohibit transfers of such options or shares under state law?
- Should the restrictive provisions of the proposed exemption apply to the securities received on exercise of the compensatory employee stock options for so long as the issuer is relying on the proposed exemption? If not, please explain.
- Should the transfer restrictions on the shares received on exercise of the compensatory employee stock options, following such exercise, be a condition to the proposed exemption only if the issuer does not restrict the transferability of any of the shares of the same class of its equity security prior to the issuer becoming subject to the reporting requirements of the Exchange Act?
- The proposed exemption provides that there can be no market or methodology that would permit optionholders or holders of shares received on exercise of an option to profit from or monetize the options, the shares received on exercise of the options, or shares of the same class of equity security as those underlying the options. These proposed restrictions are not intended to interfere with any means by which the issuer values its compensatory employee stock options for purposes of Statement of Financial Accounting Standards No. 123R (''Statement No. 123R'').[54] Do the proposed conditions affect an issuer's ability to value compensatory employee stock options for purposes of Statement 123R? If so, how would the valuation ability be affected? If affected, what alternative provisions should we consider that would not interfere with such valuation, yet not permit an optionholder or holder of shares received on exercise of an option to monetize or profit from the option, the shares received or to be received on exercise of the options, or shares of the same class of equity security as those underlying the options, prior to the issuer becoming subject to the reporting requirements of the Exchange Act?

b. Permitted Exercisability of Compensatory Employee Stock Options

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

- 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 Rule 701) who acquired the options through a gift or domestic relations order.

Request for Comment

- Should there be any restriction on the exercisability of the compensatory employee stock options while an issuer is relying on the proposed exemption?
- Should the compensatory employee stock options be required to terminate if the optionholder is no longer an employee, director, consultant or advisor of the issuer? If so, under what conditions should the options terminate?
- Should the proposed exemption be available only if the compensatory employee stock options are exercisable only for a limited time period after the optionholder ceases to be an employee, director, consultant or advisor of the issuer? If so, should such a limitation on exercise be different if such a cessation is because of death or disability, or because of a termination with cause or without cause? What limited time period should apply and why?

5. Required Information

The proposed exemption would require the issuer to provide information to optionholders and holders of shares received on exercise of compensatory employee stock options. This condition would require the issuer, for purposes of the proposed exemption, to provide the following information to optionholders (and holders of shares

[52] After an issuer becomes subject to the reporting requirements of the Exchange Act, the issuer would 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 the class of equity security underlying the compensatory employee stock options.

[53] Securities Act Rule 701(c) and (g). The securities sold in Rule 701 transactions are deemed to be restricted securities as defined in Securities Act Rule 144 [17 CFR 230.144]. The transfer restrictions in the proposed exemption are more restrictive than those in Rule 701.

[54] *See* Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004) *Share-Based Payment.*

received on exercise of compensatory employee stock options):[55]

- 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, with the optionholders and holders of shares received on exercise of the compensatory employee stock options always having been provided required financial statements that are not more than 180 days old;[56] and
- The issuer's books and records, including corporate governance documents, to the same extent that they are available to other shareholders of the issuer.

The issuer would be permitted to provide the required information (other than the issuer's books and records) to the optionholders and holders of shares received on exercise of compensatory employee stock options either by:

- Physical or electronic [57] delivery of the information; or
- Notice to the optionholders and holders of shares received on exercise of compensatory employee stock options of:

—The availability of the information on a password-protected Internet site; and

—Any password needed to access the information.

The basis of the information requirement in the proposed exemption is the information that would be required to be provided pursuant to the exemption from Securities Act registration provided in Securities Act Rule 701 if securities sold in reliance on Securities Act Rule 701 in a 12-month period exceeded $5 million. In Securities Act Rule 701, we established the type of information that employees holding compensatory employee stock options must be provided before the exercise of those options.[58] The Securities Act Rule 701 information provisions provide optionholders and other persons who purchase securities without registration under Rule 701 with important information. We believe that the ongoing provision of the same information is necessary and appropriate for purposes of the proposed exemption from Exchange Act registration.[59]

Securities Act Rule 701 provides that the required information must be provided to an optionholder a reasonable period of time before the date of exercise of the compensatory employee stock options. Rule 701 also requires that the required financial statements must be as of a date no more than 180 days before the sale of the securities (which in the case of compensatory employee stock options is the date of exercise of the options). We believe that the proposed exemption from Exchange Act registration presents the need for ongoing information to be provided to optionholders and holders of shares received on exercise of those options. As such, the proposed exemption would require that the optionholders and holders of shares received on exercise of the compensatory employee stock options always be provided the required financial statements that are not more than 180 days old.

While requiring private, non-reporting issuers to provide information, the proposed exemption would allow flexibility in the means of providing the information by permitting physical, electronic, or Internet-based delivery. Under the proposal, the issuer would be required to make its books and records available for inspection by the optionholder and holders of shares received on exercise of compensatory employee stock options to the same extent that they are available to other shareholders of the issuer.

To permit issuers to safeguard proprietary or confidential information that may be contained in the information to be provided, the proposed exemption would permit provision of the disclosure to be conditioned on the optionholder (or holder of shares received on exercise of compensatory employee stock options) agreeing to maintain the confidentiality of the information.[60] As proposed, if an optionholder (or holder of shares) chooses not to enter into such a confidentiality agreement, the exemption would permit the issuer to choose to not provide the information to that optionholder or holder of shares received on exercise of options if it allows inspection of the documents at one of the described issuer offices.

In the no-action registration relief provided to issuers to date, the staff of the Division of Corporation Finance has provided that relief only where the issuer commits to providing essentially the same Exchange Act information and reports as if it was subject to the Exchange Act reporting requirements. We believe that our experience with Securities Act Rule 701 and the combined conditions of the proposed exemption, including the eligibility and transferability provisions, alleviate the need for that level of information in the context of an on-going reporting exemption relating to compensatory employee stock options.[61] As such, we believe that the scope of information that the optionholders and holders of shares will be provided under the proposed exemption is not inconsistent

[55] The information conditions may terminate once the company becomes subject to the reporting requirements of the Exchange Act.

[56] *See* Securities Act Rule 701(e) [17 CFR 230.701(e)] for a description of the risk factor and financial statement requirements. The required information would have to be provided under the terms of the proposed exemption regardless of whether the issuer would be required to provide the information under Rule 701 (for example because the issuer did not sell $5 million in securities in a 12-month period in reliance on Rule 701).

[57] Electronic delivery of such information would have to be made in compliance with the Commission's interpretations regarding the electronic delivery of information. *See e.g.*, ''Use of Electronic Media,'' Release No. 34–42728 (April 28, 2000).

[58] *See* Rule 701 Release, note 4 *supra.* ''The type and amount of disclosure needed in a compensatory securities transaction differs from that needed in a capital-raising transaction. In a bona fide compensatory arrangement, the issuer is concerned primarily with compensating the employee-investor rather than maximizing its proceeds from the sale. Because the compensated individual has some business relationship, perhaps extending over a long period of time, with the securities issuer, that person will have acquired some, and in many cases, a substantial amount of knowledge about the enterprise. The amount and type of disclosure required for this person is not the same as for the typical investor with no particular connection with the issuer.'' *Id.*

[59] As the Commission reminded issuers when it adopted the amendments to Securities Act Rule 701 in 1999, issuers should be aware that compliance with the minimum disclosure standards for Rule 701 may not necessarily satisfy the antifraud standards of the securities laws. *See* Rule 701 Release, note 4 *supra.* (Preliminary Note 1 to Rule 701 states that issuers and other persons acting on their behalf have an obligation to provide investors with disclosure adequate to satisfy the antifraud provisions of the federal securities laws.) We recognize that the Advisory Committee has recommended modifications to Rule 701 that would affect the thresholds that would trigger the disclosure provisions of that rule. Our proposals do not address the Advisory Committee's recommendations regarding Rule 701. *See* Final Report of the Advisory Committee, at p. 92–93.

[60] This proposed provision is consistent with the related information required under Securities Act Rule 701.

[61] As the Commission also recognized when it adopted the Securities Act Rule 701 amendments in 1999, and because many issuers that have 500 or more optionholders and more than $10 million in assets are likely to have received venture capital financing (*see* for example the data in the Hand Paper, note 4 *supra*), we believe that many of these issuers already have prepared the type of disclosure required in their normal course of business, either for using other exemptions, such as Regulation D, or for other purposes. As a result, the disclosure requirement generally would be less burdensome for them. In adopting the amendments to Rule 701, we stated that a minimum level of disclosure was essential to meet even the reduced level of information needed to inform compensatory-type investors such as employees and consultants. *See* Rule 701 Release, note 4 *supra.*

with investor protection and the public interest.[62]

Request for Comment

- Should the proposed exemption require additional information to be provided? If so, what additional information should be required?
- Should the proposed exemption require that audited financial statements be provided in all cases, even if the issuer does not otherwise prepare audited financial statements?
- Should the proposed exemption also require that the information be provided in specified time frames prior to the exercise of the compensatory employee stock options?
- Should the proposed exemption require that the information be provided to holders of shares received on exercise of the compensatory employee stock options until the issuer becomes subject to the reporting requirements of the Exchange Act or for so long as the issuer is relying on the proposed exemption? If not, should there be restrictions on the information provided and, if so, what restrictions should be imposed and why?
- Should the proposed exemption apply to holders of shares received on exercise of compensatory employee stock options only if the issuer has a repurchase right in the event of an attempted transfer of the shares? If so, what information would be provided to a holder of shares prior to the issuer becoming a reporting issuer under the Exchange Act?
- As proposed, the issuer could provide the required information by physical, electronic, or Internet-based delivery. Is it appropriate to allow issuers to choose how to satisfy this requirement by using these alternate means? What role should investor preference play?
- Should the condition specifying the manner in which the information should be provided mandate that the information be available through a password-protected Internet site?
- The proposed exemption would require that issuers make their books and records available to optionholders and to holders of shares received on exercise of the options to the same extent they are available to other shareholders of the issuer. Is this an appropriate information requirement for the proposed exemption? If not, why not? What books and records and corporate governance documents do private, non-reporting issuers provide to optionholders and holders of shares received on exercise of options? Would this condition affect issuers' practices of granting options to consultants and advisors? If so, why?
- As proposed, the exemption does not require private, non-reporting issuers to provide optionholders or holders of shares received on exercise of an option with the information that would be required to be disclosed by our issuer tender offer rules (Exchange Act Rule 13e–4)[63] or going private transaction rules (Exchange Act Rule 13e–3)[64] if the compensatory employee stock options (or shares received on exercise of those options) were registered pursuant to Exchange Act Section 12(g). Should the information disclosure requirements of the proposed exemption be expanded to require disclosure of additional information such as any information that would otherwise be required by Rule 13e–3 or Rule 13e–4? If so, what information should be required to be provided?
- In addition, beneficial ownership of compensatory employee stock options not Exchange Act Section 12-registered in reliance on the proposed exemption would not trigger the beneficial ownership reporting requirements in Exchange Act Regulation 13D–G[65] unless the options were exercisable for Section 12 registered securities within 60 days. Is this the correct result?

6. Issuer Obligation To Impose the Conditions to the Proposed Exemption

For the proposed exemption to be available, a private, non-reporting issuer would be required to include the necessary limitations and conditions either in the written stock option plans or within the terms of the individual written option agreements. In addition, the transferability restrictions on the shares received on exercise of the compensatory employee stock options also must be included in the issuer's by-laws, certificate of incorporation, or a stock purchase or stockholder agreement between the issuer and the exercising optionholder or holder of shares received on exercise of an option. We believe that the self-executing nature of the proposed exemption necessitates the inclusion of the conditions to the exemption in an enforceable agreement between the issuer, the optionholders, and the holders of shares received on exercise of an option, or in the issuer's by-laws or certificate of incorporation.

Request for Comment

- Should the proposed exemption require that the conditions be contained in a particular written document or should the proposed exemption allow the conditions to be contained in any agreement between the issuer, the optionholders, and the holders of shares received on exercise of an option?
- Should the proposed exemption permit any of the conditions, including the transferability restrictions on the shares received on exercise of the compensatory employee stock options, to be included in the issuer's by-laws or certificate of incorporation?

B. Proposed Exemption for Compensatory Employee Stock Options of Exchange Act Reporting Issuers

To provide certainty regarding the obligations of issuers that already have registered the securities underlying the compensatory employee stock options under the Exchange Act, we believe it is appropriate to provide an exemption from Exchange Act registration for compensatory employee stock options of these reporting issuers.[66] The proposed exemption would be available only for an issuer that has registered under Exchange Act Section 12 the class of equity security underlying the compensatory employee stock options. Such a registration gives rise to a requirement to file the reports required under Exchange Act Section 13.[67] The filing of these reports is essential to the proposed exemption, as we believe the

[62] For a private, non-reporting issuer with a significant number of optionholders (and with more than $10 million in assets at the end of its fiscal year), we believe it is likely that such issuer either already is obligated to provide the same information to optionholders due to sales of securities in reliance on Securities Act Rule 701 or already prepares and, as such, provides such information to its shareholders. As a result, it is likely that optionholders and holders of shares received on exercise of those options already will have received such disclosures in connection with the option grants and exercises and, because of the proposed transferability restrictions on the compensatory employee stock options and the shares received or to be received on exercise of those options, will not have further investment decisions to make, until the issuer becomes subject to the reporting requirements of the Exchange Act. Consequently, we believe that the disclosure required under the proposed exemption is the appropriate level of disclosure to be provided option holders and holders of shares received on exercise of those options until the issuer becomes subject to the reporting requirements of the Exchange Act.

[63] 17 CFR 240.13e–4.

[64] 17 CFR 240.13e–3.

[65] 17 CFR 240.13d–1 through 240.13d–102.

[66] Public reporting issuers may be unclear regarding the need to comply with the Exchange Act Section 12(g) registration requirements for compensatory employee stock options if the issuer has registered under Exchange Act Section 12 the class of equity security underlying those options or has registered under the Securities Act the offer and sale of the options and the shares issuable on exercise of the options on Form S–8. Consequently, we believe the proposed exemption will provide important guidance regarding, and an appropriate exemption to eligible issuers from, the Exchange Act registration requirement for compensatory employee stock options.

[67] 15 U.S.C. 78m.

exemption is appropriate because the Exchange Act reports of those issuers will provide the appropriate information to optionholders.

As with the proposed exemption for private, non-reporting issuers, the proposed exemption for issuers subject to the reporting requirements of the Exchange Act would be available only where the options were issued pursuant to a written compensatory stock option plan and where the class of persons eligible to receive or hold compensatory employee stock options under the stock option plans was limited to those participants permitted under Securities Act Rule 701.[68] The proposed exemption from Section 12(g) registration for compensatory employee stock options of Exchange Act reporting issuers would not include any information conditions, other than those arising from the registration of the class of equity security underlying the options.

As proposed, the availability of the exemption would not be conditioned on the issuer being current in its Exchange Act reporting. We have not proposed such a condition, as it would seem inappropriate for the issuer to lose the exemption, and be required to register a class of compensatory employee stock options under Exchange Act Section 12(g), because it was late in filing a required Exchange Act report and, for the days before that report was filed, was not ''current'' in its Exchange Act reporting. We are requesting comment as to whether it would be appropriate to include a requirement in the exemption regarding the issuer's ongoing satisfaction of its Exchange Act reporting obligations.

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) will continue to apply to offers for those compensatory employee stock options. Further, the requirements of Exchange Act Section 16 also will apply to the equity securities underlying the compensatory employee stock options and the beneficial ownership reporting requirements of Exchange Act Sections 13(d) and 13(g)[69] will continue to apply if the compensatory employee stock options are exercisable for Exchange Act Section 12 registered securities.[70] The proposed exemption, therefore, would be available only to an issuer that had registered under Exchange Act Section 12 the class of equity security to be issued on exercise of the compensatory employee stock options. As a result, 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).

Request for Comment

- Should the proposed exemption apply to any issuer that is required to file Exchange Act periodic reports, whether or not the issuer has registered the class of equity security underlying the compensatory employee stock options under Exchange Act Section 12? If so, why?
- Should the proposed exemption be available only to issuers that are current in their Exchange Act reporting obligations? Should the proposed exemption be available only to issuers that, at the end of their fiscal years, are current in their Exchange Act reporting obligations? If so, why? If not, why not?
- Should the proposed exemption be available to issuers that are required to file reports under the Exchange Act solely pursuant to Section 15(d)? If so, why?
- How would the exclusion from the proposed exemption affect issuers required to file reports solely pursuant to Section 15(d) of the Exchange Act? How many issuers would be affected?
- Should the proposed exemption be available to those issuers that are not required to file Exchange Act reports but file such reports on a voluntary basis (also known as ''voluntary filers'') and, if so, why?
- Should the proposed exemption apply only to the reporting obligations under Section 13(a) of the Exchange Act and not to the application of other Exchange Act provisions, such as the tender offer provisions of Section 13(e) and Section 14(e) of the Exchange Act? Please explain.
- Is the use of the Securities Act Rule 701 definitions of eligible participants appropriate for purposes of the proposed exemption? If not, what definitions should be used to characterize the eligible optionholders? Should the eligible optionholders only be those persons permitted to be offered and sold options pursuant to a registration statement on Form S–8? If so, why?
- Should there be any restrictions on the transferability or ownership of the compensatory employee stock options, the shares received on exercise of those options, or shares of the same class of equity security as those underlying those options under the proposed exemption for reporting issuers?

C. Transition Provisions

The proposed exemption from Exchange Act Section 12(g) registration for compensatory employee stock options for private, non-reporting issuers would not affect the no-action relief from Exchange Act Section 12(g) registration of compensatory employee stock options that issuers have received from our Division of Corporation Finance. While the existing no-action letters will remain unaffected by the proposed exemption if adopted, issuers who have received such letters would be able, of course, to rely instead on the proposed exemption.

The proposed exemptions are self-executing. If the issuer becomes ineligible to rely on an applicable proposed exemption, the issuer would be permitted up to 60 calendar days from the date it became ineligible to rely on the proposed exemption to file a registration statement to register under Exchange Act Section 12(g) the class of compensatory employee stock options or, in the case of a reporting issuer, the class of equity security underlying such options.

Request for Comment

- Do the proposed transition provisions of 60 calendar days provide enough time for private, non-reporting and reporting issuers to comply with the Exchange Act Section 12 registration requirements upon the loss of an exemption for the compensatory employee stock options? Should it be 30 calendar days? 90 calendar days? If not, what time frame should be provided and why?
- Should the proposed exemptions be exclusive exemptions for Section 12 registration of compensatory employee stock options?

D. General Request for Comment

We request and encourage any interested person to submit comments on the proposed exemptions and any other matters that might have an impact on the proposed exemptions. With respect to any comments, we note that such comments are of greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments.

[68] *See* the discussion under ''Eligible Option Plan Participants,'' above, for a description of the eligible optionholders.

[69] 15 U.S.C. 78m(d) and (g).

[70] The provisions of Exchange Act Section 16 would apply to the options if the securities to be issued upon exercise of the options are registered as a class of equity security under Section 12. *See* 15 U.S.C. 78p and the rules promulgated thereunder. As a result, we do not believe it is necessary for compensatory employee stock options to be subject to Section 16 as a separate class of equity security.

III. Paperwork Reduction Act Analysis

A. Background

Certain provisions of the proposed amendments to Rule 12h–1 [71] contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[72] We are submitting these to the Office of Management and Budget (''OMB'') for review and approval in accordance with the PRA.[73] An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The title for this information is:

- Exchange Act Rule 12h–1.

The hours and costs associated with preparation of notices, maintaining Internet sites, and preparation of information to be disclosed to optionholders and holders of shares received on exercise of compensatory employee stock options for private, non-reporting issuers relying on the proposed exemption from Exchange Act Section 12(g) [74] registration constitute cost burdens imposed by the collection of information. The proposed exemption available to reporting issuers would not constitute new collections of information. The proposed amendments would not affect existing collections of information.

The proposed exemptions from Exchange Act Section 12(g) registration would be adopted pursuant to the Exchange Act. The information collection requirements related to the proposed exemption for private, non-reporting issuers would be 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 proposed amendments to Exchange Act Rule 12h–1 would 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 proposed amendments also would 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 the class of equity security underlying those options.

The proposed requirements regarding notice of information availability, Internet availability of information, and, for certain issuers, the preparation of information related to the proposed exemption from Exchange Act Section 12(g) for compensatory employee stock options of private, non-reporting issuers would, if adopted, constitute a new collection of information under the Exchange Act. The proposed information provision in the proposed exemption for private, non-reporting issuers would not be a new collection of information for those private, non-reporting issuers that also are required to provide such information to optionholders pursuant to Securities Act Rule 701 [75] or that already prepare and provide such information to their shareholders.

The collection of information would be required for those private, non-reporting issuers that rely on the proposed exemption because they had 500 or more optionholders and more than $10 million in assets at the end of their fiscal year. The issuers likely to use the proposed exemption would be those private, non-reporting issuers that had more than $10 million in assets and had used stock options to compensate employees, directors, consultants, and advisors on a broad basis. The proposed exemption from Section 12(g) registration for compensatory employee stock options of reporting issuers that have registered under Exchange Act Section 12(g) the class of equity security underlying such options does not impose any new collection of information on these reporting issuers.

C. Paperwork Reduction Act Burden Estimates

If the proposed exemption for private, non-reporting issuers is adopted, we estimate that the annual burden for responding to the collection of information in the proposed exemption would not increase significantly for most private, non-reporting issuers, due to the current disclosure provisions of Securities Act Rule 701 and the probability that such issuers already prepare such information for other purposes. The costs may increase for those private, non-reporting issuers who are not relying on Securities Act Rule 701 when they grant compensatory employee stock options or who do not prepare the information for other purposes. The cost of providing such information may increase because of the requirement in the proposed exemption for private, non-reporting issuers to provide the required information. We seek comment on the number of private, non-reporting issuers that would rely on the proposed exemption that already prepare the information required by the proposed exemption for other purposes.

Our estimates represent the burden for private, non-reporting issuers eligible to rely on the proposed exemption. Because the registration provisions of Section 12(g) apply only to 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, only those private, non-reporting issuers satisfying those thresholds would be subject to the collection of information. The Division of Corporation Finance has granted no-action relief from registration of compensatory employee stock options to 30 private, non-reporting issuers during the period 1992 through 2006. If we assume that approximately 3 new private, non-reporting issuers would be relying on the proposed exemption each year and that a certain number of private, non-reporting issuers will no longer be relying on the exemption because they have become reporting issuers, have been acquired, or have terminated business, we estimate that approximately 40 private, non-reporting issuers each year may be relying on the exemption. The proposed exemption for private, non-reporting issuers would terminate once such issuer became subject to the reporting requirements of the Exchange Act. Thus, the number of private, non-reporting issuers that may rely on the proposed exemption may vary from year to year.

For purposes of the PRA, we estimate the annual paperwork burden for private, non-reporting issuers desiring to rely on the proposed exemption and to comply with our proposed collection of information requirements to be approximately 20 hours of in-house issuer personnel time and to be approximately $24,000 for the services of outside professionals.[76] These estimates include the time and the cost of preparing and reviewing the information and making the information available to optionholders and holders of shares received on exercise of the options. We assume that the same number of private, non-reporting issuers would rely on the proposed exemption each year.

[71] 17 CFR 240.12h–1.

[72] 44 U.S.C. 3501 *et seq.*

[73] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

[74] 15 U.S.C. 78l(g).

[75] 17 CFR 230.701.

[76] For administrative convenience, the presentation of the totals related to the paperwork burden hours have been rounded to the nearest whole number and the cost totals have been rounded to the nearest hundred.

We estimate that 25% of the burden of preparation and provision of the information required by the proposed exemption is carried by the issuer internally and that 75% of the burden is carried by outside professionals retained by the issuer at an average cost of $400 per hour.[77] The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the issuer internally is reflected in hours. We request comment and supporting empirical data on the number of private, non-reporting issuers that would rely on the proposed exemption and the burden and cost of preparing and providing the information required by the proposed exemption.

D. Request for Comment

We request comment in order to evaluate the accuracy of our estimate of the burden of the collections of information.[78] Any member of the public may direct to us any comments concerning the accuracy of these burden estimates. Persons who desire to submit comments on the collection of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy of the comments to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090, with reference to File No. S7–14–07. Requests for materials submitted to the OMB by us with regard to this collection of information should be in writing, refer to File No. S7–14–07, and be submitted to the Securities and Exchange Commission, Office of Filings and Information Services, Branch of Records Management, 6432 General Green Way, Alexandria, VA 22312. Because the OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, your comments are best assured of having their full effect if the OMB receives them within 30 days of publication.

IV. Cost-Benefit Analysis

A. Background

Compensatory stock options provide a method to use non-cash compensation to attract, retain, and motivate issuer employees, directors and consultants. Since the 1990s, a number of private, non-reporting issuers have granted compensatory employee stock options to 500 or more employees, directors, and consultants. Compensatory employee stock options also are used routinely by issuers required to report under the Exchange Act.

Stock options, including stock options issued to employees under stock option plans, are a separate class of equity security for purposes of the Exchange Act. Under Section 12(g) of the Exchange Act, 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. 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, currently there is no exemption for compensatory employee stock options.

B. Summary of Proposed Amendments

We are proposing two 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.

One proposed amendment to Rule 12h–1 would provide an exemption from Exchange Act Section 12(g) registration for compensatory employee stock options of an issuer that does not have a class of securities registered under Section 12 and is not subject to the reporting requirements of Exchange Act Section 15(d), where the following conditions are present:

- Eligible optionholders are limited to employees, directors, consultants, and advisors of the issuer;
- Transferability by optionholders and holders of shares received on exercise of the options of compensatory employee stock options, the shares received, or to be received, on exercise of those options, and shares of the same class as those underlying those options is restricted; and
- Risk and financial information is provided to optionholders and holders of shares received on exercise of those options that is of the type that would be required under Rule 701 if securities sold in reliance on Rule 701 exceeded $5 million in a 12-month period.

The second proposed amendment to Exchange Act Rule 12h–1 would provide an exemption for compensatory employee stock options of issuers that are required to file reports under the Exchange Act because they have registered under Exchange Act Section 12 the class of equity security underlying those options.

1. Expected Benefits

Benefits of the proposed exemption for private, non-reporting issuers are likely to include the following: (1) Lower costs to, and reduced uncertainty for, private, non-reporting issuers desiring relief from registration under Section 12(g) for compensatory employee stock options issued to employees, directors, consultants, and advisors for compensatory purposes; (2) benefits to private, non-reporting issuers in designing and implementing employee stock option plans without regard to concerns arising from Exchange Section 12(g) registration of the compensatory employee stock options; (3) benefits to private, non-reporting issuers arising from the use of electronic or Internet-based methods of providing the information necessary to satisfy the information requirement of the proposed exemption; and (4) benefits to optionholders and holders of shares received on exercise of options of private, non-reporting issuers arising from the required provision of information under the proposed exemption.

Private, non-reporting issuers would benefit from cost savings as a result of the proposed exemption from Section 12(g) registration of their compensatory employee stock options. A number of private, non-reporting issuers that have 500 or more optionholders and assets in excess of $10 million have hired attorneys and requested no-action relief from the Division of Corporation Finance with regard to the registration of the options. The conditions to no-action relief from the Division include information provision conditions that are more extensive than in the proposed exemption. The proposed exemption, which would be self-executing if the provisions of the exemption were satisfied, would reduce the legal and other costs to a private, non-reporting issuer arising from the no-action request and relief. Such cost savings include reduced legal and accounting fees arising from both the request for no-action relief and for preparation of reports equivalent to Exchange Act reports of a reporting issuer on an ongoing basis. Because we expect that a number of the issuers that may take advantage of the proposed exemption may be smaller issuers, these cost

[77] In connection with other recent rulemakings, we have had discussions with several private law firms to estimate an hourly rate of $400 as the average cost of outside professionals that assist issuers in preparing disclosures for offerings.

[78] Comments are requested pursuant to 44 U.S.C. 3506(c)(2)(B).

savings could be significant relative to revenues.

The proposed amendments would require the same information that the issuer otherwise would be required to provide if securities sold in reliance on Securities Act Rule 701 exceeded $5 million during any consecutive 12-month period. Thus, for private, non-reporting issuers with a significant number of optionholders (and with more than $10 million in assets at the end of its fiscal year), it is likely that such issuer either already is obligated to provide the same information to optionholders due to sales of securities in reliance on Securities Act Rule 701, or already prepares and, as such, provides such information to its shareholders. Further, any private, non-reporting issuer that has received no-action relief regarding registration of its compensatory employee stock options will face reduced disclosure costs under the proposed exemption.

The proposed amendment also would benefit private, non-reporting issuers by providing the less expensive alternative of electronic or Internet-based methods of providing the information necessary to satisfy the information requirement of the proposed exemption.

Private, non-reporting issuers also would benefit from the certainty that the proposed exemption would provide in designing and implementing compensation programs and employee stock option plans. The proposed amendments would identify the eligibility provisions and transfer restrictions that would need to be contained in compensatory stock option plans or agreements, thereby lessening the need for issuers, at the time that Section 12(g) registration relief is needed for the compensatory employee stock options, to amend their stock option plans and outstanding options to include provisions that would be necessary to obtain no-action relief. The proposed exemption would help private, non-reporting issuers avoid becoming subject to the registration and reporting requirements of the Exchange Act prior to the time they have public shareholders.

Optionholders and holders of shares received on exercise of options also would benefit from the proposed exemption. The proposed exemption assures the provision of the information, including financial information that is not more than 180 days old, to optionholders and holders of shares received on exercise of options. Employees, directors, consultants, and advisors would benefit from the proposed exemption because private, non-reporting issuers would be able to use options for compensatory purposes without concern that the option grants would subject the issuer to Exchange Act registration.

The proposed exemption for reporting issuers also would benefit optionholders and holders of shares received on exercise of options. Optionholders and holders of shares received on exercise of options would have access to the issuer's publicly filed Exchange Act reports. Further, certain provisions of Sections 13, 14, and 16 would apply to the options and the securities issuable on exercise of the options. Holders of shares issued on exercise of those options would have the same rights as other shareholders of the issuer. Thus, the proposed exemption eliminates a possible disincentive for issuers to use certain compensatory employee stock options. This may be a benefit if this type of compensation is useful in attracting and retaining qualified employees that increase the issuer's competitiveness.

2. Expected Costs

Issuers would be required to satisfy the provisions of the proposed amendments, if adopted, to avoid registering under Section 12(g) their compensatory employee stock options if the registration thresholds are met at the end of the issuer's fiscal year. Private, non-reporting issuers may incur certain costs to rely on the proposed exemption including (1) costs to amend their existing employee stock option plans if the plans and option grants do not contain the restrictive and information provisions of the proposed exemption; (2) costs arising from preparing and providing the information required by the proposed exemption to the extent that the issuer does not already prepare or provide such information for other purposes; and (3) costs of maintaining an Internet site on which the information may be available if the issuer chooses to use that method to provide the required information to optionholders and holders of shares received on exercise of options.

We believe that the provisions of the proposed exemption are consistent in many respects with the restrictive provisions of other laws and rules governing option grants and, thus, the costs to private, non-reporting issuers should not be increased. The proposed exemption provisions also are consistent with or are more flexible than the existing conditions for obtaining no-action relief from the Division of Corporation Finance. Therefore, the costs to private, non-reporting issuers to prepare the information required by the proposed exemption may be the same or less than the current costs to the issuer relying on registration relief provided in a no-action letter issued by the Division of Corporation Finance.

Those private, non-reporting issuers who do not already prepare the required information will face costs if they desire to avail themselves of the proposed exemption. In addition to the costs discussed in the Paperwork Reduction Act Analysis,[79] as described below, issuers may face costs in maintaining the confidentiality of the information required to be provided, including preparation and enforcement of confidentiality agreements entered into with optionholders and holders of shares received on exercise of options. It should be noted, however, that these increased costs would be borne voluntarily, as it is within the issuer's control as to the number of optionholders it may have. Issuers would be able to perform their own cost-benefit analysis to determine whether to comply with the conditions to the exemption or avoid issuing options to 500 or more optionholders.

Private, non-reporting issuers may incur costs in providing the information required under the exemption. These costs may include printing and sending the information or making the information available on an Internet site. We request comment on the magnitude of these potential costs and whether there are any other additional potential costs.

The Division of Corporation Finance has granted no-action relief from registration of compensatory employee stock options to 30 private, non-reporting issuers during the period 1992 through 2006. If we assume that approximately 3 new private, non-reporting issuers would be relying on the proposed exemption each year and that a certain number of private, non-reporting issuers will no longer be relying on the exemption because they have become reporting issuers, have been acquired, or have terminated business, we estimate that approximately 40 private, non-reporting issuers each year may be relying on the exemption. The proposed exemption for private, non-reporting issuers would terminate once such issuer became subject to the reporting requirements of the Exchange Act. Thus, the number of private, non-reporting issuers that may rely on the proposed exemption may vary from year to year.

For purposes of the Paperwork Reduction Act, the Commission staff has estimated that the annual paperwork

[79] *See* discussion under ''PAPERWORK REDUCTION ACT ANALYSIS,'' above.

burden for private, non-reporting issuers desiring to rely on the proposed exemption and to comply with our proposed collection of information requirements to be approximately 20 hours of in-house issuer personnel time, which is equivalent to $3,500, and to be approximately $24,000 for the services of outside professionals, for a total paperwork burden cost of $27,500.[80] These estimates include the time and the cost of preparing and reviewing the information and making the information available to optionholders and holders of shares received on exercise of the options. The Commission staff assumed that the same number of private, non-reporting issuers would rely on the proposed exemption each year. The Commission staff estimated that 25% of the burden of preparation and provision of the information required by the proposed exemption would be carried by the private, non-reporting issuer internally and that 75% of the burden would be carried by outside professionals retained by the private, non-reporting issuer at an average cost of $400 per hour.[81]

Although a private, non-reporting issuer relying on the proposed exemption would benefit from cost savings associated with not having to register the compensatory employee stock options as a separate class of equity security under the Exchange Act, or obtaining no-action relief, by not doing so, an optionholder or holder of shares received on exercise of an option would not have the benefit of the disclosures contained in Exchange Act reports that the issuer otherwise would be obligated to file with us, including audited financial statements, or the disclosures required to be provided under the terms of the no-action relief.

Optionholders and holders of shares received on exercise of options also would not be able to freely sell their options or shares received on exercise of such options while the private, non-reporting issuer is relying on the proposed exemption. Optionholders and holders of shares received on exercise of such options would not be able to realize value from the options or shares until after the private, non-reporting issuer becomes subject to the reporting requirements of the Exchange Act. Many private, non-reporting issuers that grant options, however, currently restrict the transfer of securities held by holders of shares received on exercise of options, in most cases until after the issuer becomes subject to the reporting requirements of the Exchange Act or unless the issuer is acquired by another entity. In some cases, private, non-reporting issuers retain the right to repurchase options or shares received on exercise of an option. Any exercise of such repurchase right by the issuer would be a cost to such issuer.

Request for Comment

We request comment on the costs and benefits to optionholders, holders of shares received on exercise of compensatory employee stock options, private, non-reporting issuers, reporting issuers, and others who may be affected by the proposed exemptions in Rule 12h–1. We request your views on the costs and benefits described above as well as on any other costs and benefits that could result from adoption of the proposed exemptions. We also request data to quantify the costs and value of the benefits identified.

V. Consideration of Impact on the Economy, Burden on Competition and Promotion of Efficiency, Competition and Capital Formation Analysis

Section 23(a)(2)[82] of the Exchange Act requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. We are proposing 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. We also are proposing an exemption from Exchange Act Section 12(g) registration for compensatory employee stock options of issuers that have registered under Exchange Act Section 12 the class of equity security underlying those options.

We expect that the proposed exemption for private, non-reporting issuers from Exchange Act registration of compensatory employee stock options will provide necessary 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. We anticipate that the exemption would save such private, non-reporting issuers significant costs and would not require that their confidential issuer information become public prior to the issuer voluntarily determining to become a public reporting issuer. Further, we anticipate that the proposed exemption would continue to provide private, non-reporting issuers freedom to determine appropriate methods of compensating their employees, directors, consultants, and advisors without concern that they would be required to register their compensatory employee stock options as a class of equity security under Exchange Act Section 12. Thus, the proposed exemption eliminates a possible disincentive for issuers to use certain compensatory employee stock options. This may be a benefit if this type of compensation is useful in attracting and retaining qualified employees that increase the private, non-reporting issuer's competitiveness.

The proposed exemption for reporting issuers will provide certainty regarding the obligations of issuers that already have registered under the Exchange Act the securities underlying compensatory employee stock options to register those options under the Exchange Act. In addition, in the case of these reporting issuers, the optionholders would have access to the issuer's publicly filed Exchange Act reports and the appropriate provisions of Sections 13, 14, and 16 would apply to the compensatory employee stock options and the equity securities issuable on exercise of those options.

Section 3(f)[83] of the Exchange Act requires us, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

We anticipate that the proposed amendments, if adopted, would allow private, non-reporting issuers to continue to maintain the confidentiality of information regarding their business and operations through the use of confidentiality agreements with optionholders and holders of shares received on exercise of the options. For issuers that are voluntarily reporting under the Exchange Act or those reporting issuers that are subject to Exchange Act reporting under Section

[80] For administrative convenience, the presentation of the totals related to the paperwork burden hours have been rounded to the nearest whole number and the cost totals have been rounded to the nearest hundred.

[81] In connection with other recent rulemakings, we have had discussions with several private law firms to estimate an hourly rate of $400 as the average cost of outside professionals that assist issuers in preparing disclosures and conducting registered offerings. Consistent with recent rulemaking releases, we estimate the value of work performed by the company internally at a cost of $175 per hour.

[82] 15 U.S.C. 78w(a)(2).

[83] 15 U.S.C. 78c(f).

15(d), the proposed exemption from Section 12(g) for compensatory employee stock options would be unavailable and such issuers would be required to register under Exchange Act Section 12 the class of equity security underlying the options in order to take advantage of the proposed exemption.

We believe that the proposed exemption from Exchange Act registration for the compensatory stock options may beneficially affect the issuer's ability to compete for employees because it will allow such issuers to continue to use employee stock options in their compensation programs, thus enabling them to compete for such employees with both private, non-reporting issuers and public reporting issuers. The proposed exemption also will provide an eligible issuer a more efficient, self-executing exemption from Exchange Act Section 12(g) registration of compensatory employee stock options, instead of such issuer having to seek no-action relief.

The proposed exemptions do not relate to or affect capital formation, as the compensatory employee stock options covered by the proposed exemptions are issued for compensatory and not capital raising purposes.

The proposed exemptions would allow eligible issuers to continue to have freedom to determine appropriate methods of compensating their employees, directors, consultants, and advisors. For private, non-reporting issuers, these compensation decisions could be made without concern that the issuer would become subject to the Exchange Act reporting requirements before they had public shareholders.

Request for Comment

We request comment on whether the proposed rule would impose a burden on competition or whether it would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data and other factual support for their views if possible.

VI. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 603. It relates to proposed amendments to Rule 12h–1 that would provide two 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 the majority-owned subsidiaries of the issuer or its parents.

A. Reasons for the Proposed Action

Compensatory stock options provide a method to use non-cash compensation to attract, retain, and motivate issuer employees, directors and consultants. Since the 1990s, a number of private, non-reporting issuers have granted compensatory employee stock options to 500 or more employees, directors, and consultants. Compensatory employee stock options routinely are used by issuers required to report under the Exchange Act as well.

Stock options, including stock options issued to employees under stock option plans, are a separate class of equity security for purposes of the Exchange Act. Under Section 12(g) of the Exchange Act, 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. While there is an exemption from Section 12(g) registration for interests and participations in certain other types of employee compensation plans involving securities, currently there is no exemption for compensatory employee stock options.

B. Objectives

The primary objective of the proposed amendments is to provide two exemptions from Exchange Act Section 12(g) registration for compensatory employee stock options. One proposed exemption would be for compensatory employee stock options of issuers that do not have a class of securities registered under Section 12 and are not subject to the reporting requirements of Exchange Act Section 15(d). The second proposed exemption would be for compensatory employee stock options of issuers that are required to file reports under the Exchange Act because they have registered under Exchange Act Section 12 the class of equity security underlying those options.

Codifying an exemption from registration for compensatory employee stock options will provide necessary certainty to issuers in their compensation decisions and will help private non-reporting issuers avoid becoming subject to the registration and reporting requirements of the Exchange Act prior to the time they have public shareholders. For reporting issuers that have registered under Section 12 the class of security underlying the compensatory employee stock options, we believe the proposed exemption of compensatory employee stock options from Exchange Act registration is appropriate because the optionholders would have access to the issuer's publicly filed Exchange Act reports and the appropriate provisions of Sections 13, 14, and 16 would apply to the compensatory employee stock options and the equity securities issuable on exercise of those options. The proposed exemptions would allow private, non-reporting issuers, as well as reporting issuers, to continue to reward and retain employees with the issuers' securities.

C. Legal Basis

We are proposing the amendments to Rule 12h–1 under the authority set forth in Sections 12,[84] 23,[85] and 36[86] of the Securities Exchange Act of 1934, as amended.

D. Small Entities Subject to the Proposed Rules

The proposed exemptions would not affect issuers that are small entities. Exchange Act Rule 0–10(a)[87] defines an issuer to be a ''small business'' or ''small organization'' for purposes of the Regulatory Flexibility Act if it had total assets of $5 million or less on the last day of its most recent fiscal year. The registration requirements of Section 12(g) arise only if an issuer has more than $10 million in assets and has 500 or more holders of a class of equity security at the end of its most recently ended fiscal year. Small entities do not satisfy the asset threshold of Section 12(g) and therefore the proposed exemptions would not be needed by such entities until their asset size increased to more than $10 million at the end of a fiscal year.

Because the registration requirements of Section 12(g) are not implicated unless an entity has assets in excess of $10 million at the end of a fiscal year, we conclude that there are not a large number of small entities that may be impacted. We request comment on this conclusion, including any available empirical data.

E. Reporting, Recordkeeping and Other Compliance Requirements

The proposed exemptions would not affect small entities. The proposed amendments would require the same information that the issuer otherwise would be required to provide if securities sold in reliance on Securities Act Rule 701 exceeded $5 million

[84] 15 U.S.C. 78*l*.

[85] 15 U.S.C. 78w.

[86] 15 U.S.C. 78mm.

[87] 17 CFR 240.0–10(a).

during any consecutive 12-month period. Thus, for private, non-reporting issuers with a significant number of optionholders (and with more than $10 million in assets at the end of its fiscal year), it is likely that such issuer either already is obligated to provide the same information to optionholders due to sales of securities in reliance on Securities Act Rule 701 or already prepares and provides such information to its shareholders.

F. Duplicative, Overlapping or Conflicting Federal Rules

We believe that there are no rules that conflict with or duplicate the proposed amendments to Exchange Act Rule 12h–1.

G. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. Insofar as the amendments only apply to entities that are subject to Section 12(g) registration with regard to a class of equity security and, therefore, do not apply to small entities, we did not consider any alternatives to the proposed amendments specifically with respect to small entities. In connection with the proposed exemptions, we considered alternatives related to the scope of issuers eligible for the exemption, the information required to be provided, and transfer restrictions on the options and shares issuable on exercise of the options.

H. Request for Comment

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of any impact on small entities. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments.

VII. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 [88] (''SBREFA''), a rule is ''major'' if it has resulted, or is likely to result in:

- An annual effect on the economy of $100 million or more;
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment or innovation.

We request comment on whether our proposed exemptions would be a ''major rule'' for purposes of SBREFA. We solicit comment and empirical data on:

- The potential effect on the U.S. economy on an annual basis;
- Any potential increase in costs or prices for consumers or individual industries; and
- Any potential effect on competition, investment or innovation.

VIII. Statutory Basis and Text of Proposed Rule Amendments

We are proposing to amend Exchange Act Rule 12h–1 under the authority in Sections 12, 23, and 36 of the Securities Exchange Act of 1934, as amended.

List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

Text of Proposed Rule

For the reasons set out in the preamble, we propose to amend Title 17, Chapter II of the Code of Federal Regulations as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*, 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Amend § 240.12h–1 to add paragraphs (f) and (g) to read as follows:

§ 240.12h–1 Exemptions from registration under section 12(g) of the Act.

* * * * *

(f)(1) Stock options issued under written compensatory stock option plans of an issuer under the following conditions:

(i) The issuer of the stock options does not have a class of security registered under section 12 of the Act and is not required to file reports pursuant to section 15(d) of the Act;

(ii) The stock options have been issued by the issuer pursuant to one or more written compensatory stock option plans established by the issuer, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of the issuer's parents;

Note to paragraph (f)(1)(ii): All stock options issued under all of the issuer's written compensatory stock option plans on the same class of equity security will be considered part of the same class of equity security for purposes of the provisions of this section.

(iii) The stock options are held only by those persons described in Rule 701(c) under the Securities Act (17 CFR 230.701(c));

(iv) The stock options and the shares issuable upon exercise of such stock options are restricted as to transfer by the optionholder or holder of the shares received on exercise of the option other than to persons who are family members (as defined in Rule 701(c)(3) under the Securities Act (17 CFR 230.701(c)(3)) through gifts or domestic relations orders, or to an executor or guardian of the optionholder or holder of shares received on exercise of such stock option upon the death or disability of the optionholder or holder of shares, until the issuer becomes subject to the reporting requirements of section 13 or 15(d) of the Act; provided that the optionholder or holder of shares may transfer the options or shares to the issuer (or its designated affiliate if the issuer is unable to repurchase the options or shares) if applicable law prohibits a restriction on transfer;

Note to paragraph (f)(1)(iv): For purposes of this section, optionholders and holders of shares received on exercise of an option may include any permitted transferee under paragraph (f)(1)(iv) of this section; provided that such permitted transferees may not further transfer the stock options or shares issuable upon exercise of such stock options;

(v) The stock options, the shares issuable upon exercise of such stock options, and shares of the same class of equity security as those underlying the options are restricted as to any pledge, hypothecation, or other transfer, including any short position, any ''put equivalent position'' (as defined in § 240.16a–1(h) of this chapter), or any ''call equivalent position'' (as defined in § 240.16a–1(b) of this chapter) by the optionholder or holder of shares received on exercise of an option, except as permitted in paragraph (f)(1)(iv) of this section, until the issuer becomes subject to the reporting requirements of section 13 or 15(d) of the Act;

(vi) There can be no market or available process or methodology that permits an optionholder or holder of shares received on exercise of an option to receive any consideration or compensation for the options, the shares issuable on exercise of the options, or shares of the same class of equity security as those underlying the options,

[88] Pub. L. 104–121, Title II, 110 Stat. 857 (1996).

except as permitted in paragraph (f)(1)(iv) of this section, until the issuer becomes subject to the reporting requirements of section 13 or 15(d) of the Act;

Note to paragraphs (f)(1)(iv), (f)(1)(v), and (f)(1)(vi): The transferability restrictions in paragraphs (f)(1)(iv), (f)(1)(v), and (f)(1)(vi) of this section must be contained in either the written compensatory stock option plan, individual written compensatory stock option agreement, or other stock purchase or stockholder agreement to which the issuer and the optionholder or holder of shares are a signatory or party, or in the issuer's by-laws, certificate of incorporation; and

(vii) The issuer has agreed in the written compensatory stock option plan or the individual written compensatory stock option agreement to provide the following information to optionholders and holders of shares received on exercise of an option until the issuer becomes subject to the reporting requirements of section 13 or 15(d) of the Act:

(A) The information described in Rules 701(e)(3), (4), and (5) under the Securities Act (17 CFR 230.701(e)(3), (4), and (5)), with such information provided either by physical or electronic delivery to the optionholders and holders of shares received on exercise of an option or by written notice to the optionholders and holders of shares received on exercise of an option of the availability of the information on a password-protected Internet site and of any password needed to access the information; and

(B) Access to the issuer's books and records, including corporate governance documents, to the same extent that they are available to other shareholders of the issuer.

Note to paragraph (f)(1)(vii): The issuer may request that the optionholder or holder of shares received on exercise of an option agree to keep the information to be provided pursuant to this section confidential. If an optionholder or holder of shares received on exercise of an option does not agree to keep the information to be provided pursuant to this section confidential, then the issuer is not required to provide the information; provided, that the issuer must then allow the optionholder or holder of shares received on exercise of an option to inspect the information and documents at one of the issuer's offices that is at or near where the optionholder or holder of shares received on exercise of an option is or was employed or retained by the issuer.

(2) If the exemption provided by paragraph (f)(1) of this section ceases to be available, the issuer of the compensatory stock options that is relying on the exemption provided by this section must file a registration statement to register the class of options under section 12 of the Act within 60 calendar days after the conditions in paragraph (f)(1) of this section are no longer satisfied.

(g)(1) Stock options issued under written compensatory stock option plans of an issuer under the following conditions:

(i) The issuer of the stock options has registered the class of equity security issuable on exercise of the options under section 12 of the Act;

(ii) The stock options have been issued by the issuer pursuant to one or more written compensatory stock option plans established by the issuer, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of the issuer's parents;

Note to paragraph (g)(1)(ii): All stock options issued under all of the issuer's written compensatory stock option plans on the same class of equity security will be considered part of the same class of equity security for purposes of the provisions of this section; and

(iii) The stock options are held only by those persons described in Rule 701(c) under the Securities Act (17 CFR 230.701(c)).

(2) If the exemption provided by paragraph (g)(1) of this section ceases to be available, the issuer of the compensatory stock options that is relying on the exemption provided by this section must file a registration statement to register the class of options or the class of equity security issuable on exercise of the options under section 12 of the Act within 60 calendar days after the conditions in paragraph (g)(1) of this section are no longer satisfied.

Dated: July 5, 2007.

By the Commission.

Nancy M. Morris,

Secretary.

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