

[Home](#) | [Print](#)**01/11/08*****Exemption for Exchange Act Registration of
Compensatory Stock Options***

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As we reported in our Client Alert dated December 3, 2007, the Securities and Exchange Commission ("SEC") has adopted amendments to Rule 12h-1 under the Securities Exchange Act of 1934 ("Exchange Act") to provide exemptions from Section 12(g) registration for compensatory stock options. The SEC adopted two separate exemptions in the amendments — one for issuers that are not subject to the reporting requirements of the Exchange Act and one for issuers that are. The amendments were effective December 7, 2007. This memorandum discusses the exemptions in additional detail.

Under Exchange Act Section 12(g), any company that issues securities and has 500 or more holders of record of a class of equity securities and more than \$10 million of assets at the end of its most recent fiscal year is required to register that class of equity securities, unless an exemption from registration is available. As stock options are considered a class of equity security under the Exchange Act (separate from the class that underlies such options), prior to the amendments such companies were required to register stock options under the Exchange Act if there were 500 or more holders of record of such options and the company had more than \$10 million in assets at the end of its fiscal year, unless an exemption was otherwise available. Prior to the amendments there was no exemption from Section 12(g) registration for stock options, including compensatory stock options, even though Rule 701 under the Securities Act of 1933 ("Securities Act") provides an exemption from the registration provisions of that Act for compensatory stock options issued by non-reporting issuers in compliance with the rule. Instead, non-reporting companies faced with the requirement to register compensatory stock options have relied on relief granted pursuant to no-action letters issued by the SEC's Division of Corporation Finance. The amendments provide such an exemption as

long as the options are issued pursuant to written compensatory stock option plans of the company, its parents, or majority-owned subsidiaries of the company or its parents, and otherwise in compliance with the requirements of the applicable exemption, as further discussed below. The exemptions do not, however, extend to the class of equity security underlying such options. Therefore, if the securities underlying the options become held by 500 or more holders of record and the company has \$10 million in assets at the end of its fiscal year, the company must still register the underlying security under Section 12(g) of the Exchange Act.

For purposes of the exemptions, compensatory stock options are considered to belong to the same class of equity security if the same class of equity security underlies such option, even if issued under different written compensatory plans and/or with different exercise terms.

I. Exemption for Compensatory Stock Options Issued by Non-Reporting Companies

The first exemption applies to companies that do not have a class of security registered under Section 12 and are not obligated to file reports under Section 15(d) of the Exchange Act. In order for options to be eligible for the exemption, (i) the options must be issued under a written compensatory plan as described above, (ii) the options must be held only by the class of persons described in Rule 701(c) under the Securities Act, (iii) the options, and prior to exercise the securities underlying such options, must be restricted as to transfer, and (iv) the company must provide to option holders the same information that would be required pursuant to Rule 701 if it sold more than \$5 million worth of securities in a 12-month period in reliance on that rule.

The exemption will terminate once the company becomes subject to the Exchange Act's reporting requirements or if it no longer qualifies for the exemption. If the exemption becomes no longer available as to a class of options, the issuing company has 120 days within which to file a registration statement to register that class of options under Section 12 of the Exchange Act.

A. Eligible Holders

In order to qualify for the exemption, the stock options may be held only by those class of persons enumerated in Rule 701(c), including employees, directors, general

partners, trustees (where the issuer is a business trust), officers, consultants and advisors of the company, its parents, or majority-owned subsidiaries of the company or its parents, and their permitted transferees as described under "Transfer Restrictions" below.

B. Transfer Restrictions

In order to qualify for the exemption, the options and, prior to exercise, the securities underlying such options must be restricted such that they cannot be transferred except (i) to family members (as defined in Rule 701 (c) ¹) by gift or pursuant to domestic relation orders, or (ii) to an executor or guardian upon the option holder's death or disability. Permitted transferees may not be permitted to further transfer the options.

In addition, the stock options and, prior to exercise, the shares issuable upon their exercise must be restricted as to any pledge, hypothecation or other transfer, including any short position, "put equivalent position" ² or "call equivalent position." ³

In both cases, the options and shares underlying the options must be so restricted until the company becomes subject to the Exchange Act's reporting requirements or is no longer relying on the exemption. In addition, the transfer restrictions must be included in the plan, agreements under the plan, other stock purchase or stockholder agreement to which both the company and option holder are bound, other enforceable agreement by or against the company and option holder, or in the company's bylaws or its certificate or articles of incorporation.

Transfers are permitted, however, back to the company or in connection with a change of control or other acquisition transaction involving the company if after such transaction the options will no longer be outstanding and the company will no longer be relying on the exemption.

The SEC's original proposal to extend these transfer restrictions to the securities underlying the options after exercise and to

any securities of the same class was not adopted.

C. Informational Requirements

In order to qualify for the exemption, the company must have agreed in either the plan, the agreements under the plan or another agreement to provide to option holders, once it is relying on the exemption and then until it is subject to the Exchange Act's reporting requirements or is otherwise no longer relying on the exemption, the same information that it would be required to provide under Rule 701 if it was issuing more than \$5 million worth of securities in a 12-month period (or any amended amount under Rule 701) in reliance on Rule 701. This includes information about the risks of investing in the securities underlying the options and certain financial statements. The company must provide this information to option holders at least every six months, with option holders receiving financial statements that are no more than 180 days old.

The company can provide this information in written or electronic form or by notice of the availability of the information on an Internet web site as well as any password necessary to access the information if password-protected. The company may, however, require option holders to keep the required information confidential and decline to provide the information to any holder who does not so agree. Further, the company is not required to deliver this information to holders of shares received upon exercise of the options who no longer hold options.

The proposed requirement to provide option holders with access to the company's books and records was not adopted.

D. Interplay with Rule 701

The requirements with respect to a written compensatory plan and the class of persons that may be issued options are the same under both Securities Act Rule 701 and the new registration exemption for non-reporting issuers under Exchange Act Rule 12h-1. Therefore, these provisions should not cause any additional hardship for companies issuing options pursuant to Rule 701 that seek to

take advantage of the new Exchange Act registration exemption. While the informational requirements of the rules are the same as to what information needs to be provided to option holders, the new Rule 12h-1 exemption requires that this information be delivered to all option holders, while under Rule 701 the information need only be delivered if the amount of securities sold under the exemption exceeds \$5 million in 12 months. Thus, companies relying on the Rule 701 exemption for Securities Act registration will have to provide this information to option holders if they plan to take advantage of the new Rule 12h-1 exemption, even if they do not need to do so to take advantage of the Rule 701 exemption because they do not exceed the thresholds set forth in Rule 701.

Non-reporting companies that currently rely on Rule 701 to exempt the sale of their securities pursuant to stock options from registration under the Securities Act should confirm the number of holders of record of their compensatory stock options and consider whether they may need to take advantage of this new exemption to avoid having to register the options under the Exchange Act. If so, the company may have to amend its stock option plans and/or enter into agreements with existing option holders that incorporate the transfer restrictions and company informational obligations required by the exemption, and prepare to start providing the necessary information to option holders.

II. Exemption for Compensatory Employee Stock Options of Exchange Act Reporting Companies

The second exemption applies to options issued (i) by companies that have a class of equity security registered under Section 12 of the Exchange Act or are required to file periodic reports pursuant to Section 15(d) under the Exchange Act, and (ii) pursuant to written compensatory stock option plans of the company, its parents, or majority owned subsidiaries of the company or its parents. Companies need not be current in their periodic reporting obligations in order to rely on the exemption. As with the exemption for non-reporting companies, the stock options may be held only by those persons enumerated in Securities Act Rule 701(c), but reporting companies can still rely on the exemption even with an "insignificant deviation" from this requirement if after December 7, 2007 the

company has made a "good faith and reasonable attempt" to comply with the requirement. The amendments provide that an insignificant deviation exists if the number of option holders that do not meet the requirement is insignificant as to both the aggregate number of holders and number of outstanding options.

If the exemption ceases to be available, the company must file a registration statement to register the class of options within 60 days after the exemption is no longer available.

Since companies eligible to take advantage of this exemption are already required to file periodic reports under the Exchange Act, we expect this exemption to have little practical impact. However, reporting companies will want to ensure that the terms of their stock option plans comply with the exemption if they want to take advantage of the exemption to avoid the need to track the number of option holders of record and the need to register their options under Section 12 should the number of record holders reach 500 and their assets exceed \$10 million.

This memorandum contains only a general summary of the amendments to Rule 12h-1 and should not be construed as providing legal advice. The adopting release with respect to the amendments, including the text of the amendments, is available at www.sec.gov/rules/final/2007/34-56887.pdf (for the *Federal Register* version go to: <http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/E7-23756.pdf>).

If you have any questions about the information in this Memorandum, please contact Frank C. Bonaventure at **410-347-7305** or fcbonaventure@ober.com or Penny Somer-Greif at **410-347-7341** or psomergreif@ober.com.

NOTES

¹ Pursuant to Rule 701(c)(3), "family member" includes "any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, former spouse, sibling, niece, nephew, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, including adoptive relationships, any person sharing the

employee's household (other than a tenant or employee), a trust in which these persons have more than fifty percent of the beneficial interest, a foundation in which these persons (or the employee) control the management of assets, and any other entity in which these persons (or the employee) own more than fifty percent of the voting interests."

² As defined in Rule 16a-1(h) under the Exchange Act, a "put equivalent position" means "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."

³ As defined in Rule 16a-1(b) under the Exchange Act, a "call equivalent position" means "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."

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