

December 10, 2007

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

On November 15, 2007, the SEC adopted final rules amending Exchange Act Rule 12h-1 to provide relief from Exchange Act registration of compensatory employee stock options for (i) private, non-reporting companies that issue options to 500 or more eligible participants under their option plans and (ii) public reporting companies that are required to file periodic reports under Exchange Act Section 13 or Section 15(d).

Although the final rules are substantially the same as those proposed in July 2007, some noteworthy modifications are as follows:

- Exemption for private, non-reporting issuers:
  - elimination of transferability and ownership restrictions on holders of equity securities issued on exercise of compensatory stock options;
  - modification of the option transferability condition to permit option holders to receive compensation for their options from the issuer or arising from a change of control or other acquisition transaction after which the options no longer will be outstanding and the issuer no longer will be relying on the exemption;
  - elimination of the requirement for an issuer to repurchase options if an express prohibition on transfer of options is not permitted under applicable state law;
  - elimination of the issuer's obligation to provide certain required information to holders of equity securities received on exercise of compensatory employee stock options;
  - elimination of the issuer's obligation to provide holders of compensatory employee stock options access to its books and records; and
  - granting of up to 120 calendar days (60 calendar days more than was proposed) to register the class of compensatory employee stock options under the Exchange Act upon termination of the exemption.

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- Exemption for public reporting issuers:
  - expansion of the category of issuers eligible to rely on the exemption to include any issuer required to file periodic reports under Exchange Act Section 13 or Section 15(d);
  - expansion of the class of persons eligible to receive options under the exemption to include participants permitted to be granted options under an issuer’s Form S-8, as well as to those participants permitted under Securities Act Rule 701; and
  - modification of the option holder eligibility condition to permit the exemption to continue to be available even if there is an “insignificant deviation” from satisfying the eligibility condition of the exemption.

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

These amendments became effective as of December 7, 2007. For a copy of the release, see <http://www.sec.gov/rules/final/2007/34-56887.pdf>.

### **Exemption for Compensatory Employee Stock Options of Non-Reporting Issuers**

Under the new amendments, non-reporting issuers are eligible for an exemption from registration under the Exchange Act for compensatory employee stock options issued under a written compensatory stock option plan as long as (a) eligible option holders are limited to persons to whom offers and sales of securities under written compensatory benefit plans may be made in reliance on Securities Act Rule 701, (b) transferability of the compensatory stock options and, prior to exercise, the underlying equity securities receivable on exercise of the options is restricted, and (c) certain risk and financial information is provided to holders of the options that is of the type that would be required under Securities Act Rule 701 if securities sold in reliance on Securities Act Rule 701 exceeded \$5 million in any 12-month period.

#### ***Eligible Issuers***

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

#### ***Eligible Compensatory Employee Stock Options***

The exemption applies only to compensatory employee stock options that are issued under one or more written compensatory stock option plans that are limited to eligible option plan participants as described below. Compensatory employee stock options are considered to belong to the same class of equity security if the same class of securities would be issuable on exercise of the options, even if issued under separate written compensatory stock option plans. This requirement is consistent with Securities Act Rule 701, which is available only for offers and sales

of compensatory employee stock options and the equity securities issuable upon exercise of those options that are issued under written compensatory employee benefit plans of an issuer, its parents, or any majority-owned subsidiary of either the issuer or its parents.

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

### ***Eligible Option Plan Participants***

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

- employees (including specified insurance agents);
- directors;
- general partners;
- trustees (where the issuer is a business trust);
- officers;
- consultants and advisors (under certain conditions);
- family members who acquire their securities from such persons through gifts or domestic relations orders; and
- former employees, directors, general partners, trustees, officers, consultants, and advisors only if such persons were employed by or providing services to the issuer at the time the securities were offered.

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

### *Option Terms*

#### *Transferability Restrictions on Compensatory Employee Stock Options*

The exemption is available only where the following restrictions are imposed by the written compensatory stock option plan on the transferability by a holder of the compensatory employee stock options and, prior to the exercise of the options, the underlying equity securities receivable on exercise of those options:

- the compensatory employee stock options and, prior to exercise, the underlying equity securities receivable on exercise of the options are not transferable except as permitted by the exemption (a) to family members (as defined in Securities Act Rule 701) by gift or pursuant to domestic relations orders or (b) on death or disability of the option holder, until the issuer becomes subject to the reporting requirements of the Exchange Act or is no longer relying on the exemption, other than transfers of such options to the issuer or transfers in connection with a change of control or other acquisition transactions involving the issuer if, following such transaction, the options no longer will be outstanding and the issuer no longer will be relying on the exemption;
- holders of options through a permitted transfer from the original holder, as described above, may not transfer those options further; and
- the compensatory employee stock options or the underlying equity securities receivable on exercise of the options cannot be the subject of a pledge, a hypothecation or other transfer, including any short position, any “put equivalent position,” or any “call equivalent position,” by the holder thereof, prior to exercise, until the issuer becomes subject to the reporting requirements of the Exchange Act or is no longer relying on the exemption, other than transfers of such options to the issuer or transfers in connection with a change of control or other acquisition transactions involving the issuer if, following such transaction, the options no longer will be outstanding and the issuer no longer will be relying on the exemption.

These transfer restrictions are similar to those contained in the existing line of no-action letters and substantially consistent with transfer restrictions on stock options under Securities Act Rule 701, with the exception that the amendment does not restrict holders of equity securities following exercise of compensatory employee stock options. Such restrictions are intended to limit the possibility for a trading market to develop for the compensatory employee stock options while the issuer is relying on the exemption. They are also intended to assure that a holder of the compensatory employee stock options is not able to profit from those options or the securities receivable on exercise of those options (except from permitted payments or transfers as described in the exemption) until the issuer becomes subject to the reporting requirements of the Exchange Act or is no longer relying on the exemption.

In order to avoid potential adverse accounting consequences to companies that might apply if an issuer were required to repurchase the underlying equity securities or options where an express prohibition on the transfer of compensatory employee stock options is not permitted under applicable state law, the SEC modified its proposed transferability conditions to provide that an

issuer may (but is not required to) repurchase the options in the event of an impermissible transfer. Under the new rules, issuers may also provide that the options terminate in such an event.

#### *Permitted Exercisability of Compensatory Employee Stock Options*

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

#### ***Required Information***

For purposes of the exemption, the issuer is required to provide its option holders every six months the same risk and financial information that it would be required to provide under Securities Act Rule 701 if securities sold in reliance on Securities Act Rule 701 exceeded \$5 million in any consecutive 12-month period, including financial statements that are not more than 180 days old. The issuer would be required to provide such information whether or not securities sold in reliance on Securities Act Rule 701 exceed \$5 million in any consecutive 12-month period.

The SEC had initially proposed a much broader information requirement for issuers, but in adopting the final rules, the SEC dropped its proposal to require issuers to provide Securities Act Rule 701 information to holders of equity securities received on exercise of the compensatory employee stock options as well as to option holders. In addition, the SEC decided not to adopt its proposal to require issuers to provide option holders and holders of equity securities received on exercise of the options access to their books and records, including corporate governance documents. The SEC reasoned that holders of such securities could exercise their state law rights, if any, to inspect corporate books and records.

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

This information requirement under the exemption represents a departure from the requirement set forth in the existing line of no-action letters, wherein the SEC staff provided relief only where the issuer committed to providing essentially the same information and reports as if it were an Exchange Act reporting issuer. These more relaxed information requirements stem from the SEC's belief that experience with Securities Act Rule 701 and the combined conditions of the

exemption, including the eligibility and transferability provisions, alleviate the need for the level of information called for by prior no-action letters in the context of an on-going reporting exemption relating to compensatory employee stock options.

### ***Issuer Obligation to Impose the Conditions to the Exemption***

For the exemption to be available, a non-reporting issuer is required to include the limitations and conditions set forth above in the written compensatory stock option plans, within the terms of the individual written stock option agreements or in another enforceable written agreement or in its by-laws or certificate of incorporation.

### ***Termination of Exemption***

The exemption will terminate if the issuer becomes subject to the reporting requirements of the Exchange Act or the issuer no longer satisfies the conditions to the exemption. Upon termination of the exemption, an issuer will have up to 120 calendar days from the date it became ineligible to rely on the exemption to register the class of options under the Exchange Act. As a result, a pre-IPO issuer relying on the exemption will become ineligible if it becomes subject to an obligation under Exchange Act Section 15(d) (e.g., as a result of a registered exchange offer following an offering of debt securities under Securities Act Rule 144A).

### **Exemption for Compensatory Employee Stock Options of Reporting Issuers**

The amendments also provide a separate exemption for compensatory employee stock options of reporting issuers that have already registered securities under the Exchange Act or are required to file reports under Exchange Act Section 13 or Section 15(d). Most reporting issuers currently do not register compensatory stock options under Exchange Act Section 12(g) when the underlying securities are registered under the Exchange Act and the sale of the options and the equity securities issuable on exercise of the options are registered under the Securities Act on Form S-8. Because, in the SEC's view, public companies may be "unclear" as to the need to register compensatory employee stock options under the Exchange Act in these circumstances, the SEC expressed its view that the exemption will provide important guidance regarding, and an appropriate exemption to eligible issuers from, the Exchange Act registration requirements for compensatory stock options.

### ***Eligible Issuers***

While the exemption as originally proposed would have been available only for an issuer that had registered under Exchange Act Section 12 the class of equity security underlying the compensatory employee stock options, the SEC expanded the eligibility for this exemption to all issuers required to file periodic reports pursuant to Exchange Act Section 13 or Exchange Act Section 15(d). In the SEC's view, the filing of such Exchange Act reports will provide appropriate information to the public, including holders of compensatory employee stock options and the underlying equity securities receivable on exercise of the options.

### ***Eligible Compensatory Employee Stock Options***

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

### ***Eligible Option Plan Participants***

As originally proposed, the exemption for reporting issuers was available only where the class of persons eligible to receive compensatory employee stock options pursuant to the terms of the written compensatory stock option plans is limited to persons to whom offers and sales of securities under written compensatory benefit plans may be made in reliance on Securities Act Rule 701. In its final rules, the SEC revised the exemption, in response to public comment, to provide that the class of persons eligible to receive or hold compensatory employee stock options under the stock option plans includes those participants permitted to be granted options under an issuer's Form S-8, as well as those participants permitted under Securities Act Rule 701. This change was made to take into account the fact that, for a reporting issuer, compensatory employee stock options may have been granted before, and may be granted after, the issuer becomes subject to the Exchange Act reporting requirements.

The SEC also modified the option holder eligibility condition to permit the exemption to continue to be available even if there is an "insignificant deviation" from satisfying the eligibility conditions of the exemption. This provision will allow reporting issuers to rely on the exemption if the option holders that do not meet the eligibility condition are insignificant both as to the aggregate number of option holders and number of outstanding options, and, after the effective date of the new amendments, the issuer must have made a good faith and reasonable attempt to comply with the option holder eligibility conditions of the exemption.

### ***Required Information***

The exemption for reporting issuers does not include any information requirements, other than those arising from the registration of a class of security under the Exchange Act or arising under Exchange Act Section 15(d). In addition, the exemption is not conditioned on the issuer being current in its Exchange Act reporting. For issuers required to file periodic reports pursuant to Exchange Act Section 15(d), the exemption will no longer be available if their obligation to file reports under Exchange Act Section 15(d) is suspended. In that case, to maintain the exemption, the issuer would have to register a class of equity security under Exchange Act Section 12.

### ***Termination of Exemption***

If a reporting issuer becomes ineligible to rely on the exemption, the issuer will have up to 60 calendar days from the date it became ineligible to rely on the exemption to register the class of options under the Exchange Act.

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