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Ms. Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

File No. S7-14-07
Exemption of Compensatory Employee Stock Options from Registration under Section 12(g) of the Securities Exchange Act of 1934
Release No. 34-56010; International Series Release No. 1303

Dear Ms. Morris:

KPMG LLP appreciates the opportunity to comment on the Securities and Exchange Commission's proposed rule, "Exemption of Compensatory Employee Stock Options from Registration under Section 12(g)" (Proposed Rule). Our comments focus on how a company's accounting for employee stock options might be impacted by the Proposed Rule.

Transferability Restrictions

The Proposed Rule provides that in order to qualify for exemption from registration, the transferability of the options, securities issued or issuable upon exercise of the options, and the shares of the same class of securities underlying the options must be restricted until the issuer becomes subject to the reporting requirements of the Exchange Act of 1934 (Exchange Act). This restriction is intended to limit the development of a trading market in the options or shares issued upon exercise of the options until the company becomes subject to the requirements of the Exchange Act. The transferability restrictions are not, however, intended by the SEC to interfere with the way an issuer values its options for purposes of applying FASB Statement of Financial Accounting Standards No. 123(R), *Share-Based Payments* (Statement 123R).

In analyzing the potential impact of the proposed transferability restrictions on valuing employee stock options, two of the key inputs used in calculating the value of the options must be considered: the expected term assumption and the fair value of the shares to be issued upon exercise of the option.

With respect to the expected term assumption, paragraph 17 of Statement 123R states that "for equity share options and similar instruments, the effect of nontransferability (and nonhedgeability, which has a similar effect) is taken into account by reflecting the effects of employees' expected exercise and post-vesting employment termination behavior in estimating fair value (referred to as an option's expected term)". We have observed that the expected term assumption used by a non-public company in calculating the value of its employee stock options issued with no transferability restrictions normally does not anticipate early exercise of the option. This assumption is generally appropriate because employees of non-public companies normally have no incentive to exercise a vested option early since there is no market for the underlying shares. Therefore, non-public company employee behavior typically is to hold the option until the end of its contractual term, termination of employment, or until a liquidity event such as an IPO or sale of the company provide an incentive to exercise the option. Therefore, we would not expect the proposed transferability restriction to affect the expected term assumption used by most non-public companies. In the unusual situation where a non-public company believes that a shorter expected term assumption is appropriate, they will need to modify the expected term assumption for options granted after the Proposed Rule is effective to reflect the proposed transferability restriction.

Under the Proposed Rule, the transferability restriction will also apply to the shares to be issued upon exercise of the options and, therefore, should be considered in estimating the fair value of the restricted shares at the grant date for use in the option pricing model. Paragraph B74 of Statement 123R provides the following guidance:

> Certain post-vesting restrictions, such as a contractual prohibition on selling shares for a specified period of time after vesting, are essentially the same as restrictions that may be present in equity instruments exchanged in the marketplace. For those restrictions, either a market price of a similar traded instrument or, if one is not available, the same valuation techniques used to estimate the fair value of a traded instrument are to be used to estimate the fair value of a similar instrument awarded to employees as compensation.

Similarly, the AICPA practice aid "Valuation of Privately-Held-Company Equity Securities Issued as Compensation" also identifies restrictions on transferability as a relevant consideration in determining whether a marketability discount is appropriate.

However, in practice we believe that such discounts would rarely be significant. The proposed transferability restrictions notwithstanding, the value of the shares of a non-public company will already reflect the fact that the shares cannot be widely traded. Further, the ongoing cost to an entity of a restricted share is very similar to the cost of an unrestricted share. In addition, while restrictions may be burdensome to a specific holder, they are likely to be less important to longer-term investors, such as employees who accept options on shares of a non-public company as a component of their compensation. Finally, the method used to estimate any discount attributed to the proposed transferability restriction should be objective and reliable. In practice, it will often be difficult for a non-public company to provide objective, verifiable evidence of such a discount. We

therefore believe the proposed transferability restrictions generally will not significantly affect the estimated fair value of the restricted shares to be issued upon exercise of the options.

Based on the above, we do not believe the proposed transferability restrictions would significantly affect the expected term assumptions or share value estimates used in calculating the estimated grant date fair value of employee stock options for most non-public issuers and hence will not interfere with the way they value options under Statement 123R.

Repurchase provision

As currently written, Exchange Act Rule 12h-1(f)(1)(iv) restricts transferability of the options and shares issued or issuable upon exercise of the options except 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". The above language appears to permit, but not to require, an issuer subject to such state laws to retain an obligation to repurchase the shares or options. Footnote 48 of the adopting release provides the following regarding this situation:

> 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.

Footnote 48 appears to require, not just permit, that an issuer subject to such state laws retain an obligation to repurchase the shares or options in order to qualify for the exemption from registration. We recommend that the final rule be clarified with respect to what is actually required to qualify for the exemption from registration in this situation.

The requirement for the issuer to retain the obligation to repurchase "the options or the shares" as stated in footnote 48 may require the issuer to classify the award as a liability under Statement No. 123R. Statement 123R treats a put on a share award differently from a put on an option. It is therefore important to distinguish whether the issuer is required to include a put on both the option and the share or whether the issuer can satisfy the requirement by including the put on either the option or the share.

Paragraph 31 of Statement 123R requires that a puttable share be classified as a liability if either of the following conditions is met:

> (a) the repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the requisite service is rendered and the share is issued, or

> (b) it is probable that the employer would prevent the employee from bearing those risks and rewards for a reasonable period of time from the date the share is issued. For this purpose, a period of six months or more is a *reasonable period of time*.

Paragraph 32 of Statement 123R would apply to an award where both the option and the underlying shares include a put feature and is as follows:

> Options or similar instruments on shares shall be classified as liabilities if (a) the underlying shares are classified as liabilities or (b) the entity can be required under any circumstances to settle the option or similar instrument by transferring cash or other assets.

Therefore, if an issuer can limit the put feature to the underlying share, the award would not be disqualified from equity classification, assuming that the put could not be exercised for at least six months. However, if the put feature applies to both the option and the underlying shares, paragraph 32 of Statement 123R would require the award to be classified as liability. Liability classified awards can be especially burdensome for non-public companies because a third-party appraisal is typically required at each reporting date in order to calculate the fair value of the award. We recommend that the SEC consider whether the Proposed Rule could be revised in such a way that companies subject to state laws prohibiting transferability restrictions could take advantage of the proposed exemption from registration without imposing conditions on those awards that would result in liability classification under Statement 123R. We also suggest the final rule be clarified with respect to whether the repurchase obligation is required to apply to both the option and the underlying share.

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We would be pleased to discuss our comments at any time. Please contact Glen Davison at (212) 909-5839 or gdavison@kpmg.com or Melanie Dolan at (202) 533-4934 or mdolan@kpmg.com.

Very truly yours,

KPMG LLP