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

Proposed Rule: Exemption of Compensatory Employee Stock Options From Registration Under Section 12(g) of the Securities Exchange Act of 1934 (Release No. 34-56010) Commission File No. S7-14-07

Dear Ms. Morris:

Ernst & Young LLP is pleased to respond to the request for comment by the Securities and Exchange Commission (the Commission or the SEC) on its proposal *Exemption of Compensatory Employee Stock Options From Registration Under Section 12(g) of the Securities Exchange Act of 1934* (the Proposed Rule). Our comments are limited to those aspects of the proposal that relate to financial reporting matters.

Accounting Implications Under SFAS 123(R)

Valuation Effects of Transferability Restrictions

As a condition of the proposed exemption from registration, Exchange Act Rule 12h-1(f)(1) would require the issuer to impose strict conditions on the stock options and the shares issuable upon exercise of those stock options. Those restrictions must prohibit the ability of the holder, with limited exceptions, to transfer, pledge, hypothecate or otherwise hedge the stock options or shares of the class of equity underlying those options. The related restrictions would be required in the issuer's by-laws, certificate of incorporation, option plan or individual option agreement.

The SEC's proposing release indicates that these transferability restrictions are not intended to interfere with the ability of a nonpublic company to value its options for purposes of Statement of Financial Accounting Standards No. 123R (''SFAS 123R''). In our view, such restrictions generally should not affect the ability of a nonpublic company to value its stock options for purposes of SFAS 123R. In our experience, such valuations usually presume that the holder will not exercise the stock option until the earlier of (a) the termination of employment, (b) a liquidity event involving the employer (e.g., an initial public offering or sale of the company), or (c) the

expiration date of the option. That is, unlike stock options of public companies, the valuation of nonpublic company stock options generally does not contemplate that the holder will exercise the stock options in order to realize value through the sale or transfer of the underlying shares, absent a liquidity event.

As a practical matter, the proposed exemption should contemplate the potential acquisition of the nonpublic company by either a strategic or a financial buyer (i.e., a liquidity event). Many private companies do not ultimately become public companies as a result of an initial public offering (IPO) or registration under the Exchange Act. Instead, many private companies are ultimately acquired. As proposed, for options designed to satisfy the proposed exemption, it appears that the transfer restrictions would not allow the option holder to participate in an exchange transaction involving a change in control of the issuer. It seems that the objective of the exemption still would be achieved if option holders were allowed to participate in such a transaction. However, if the acquirer is also a nonpublic company, the Commission could consider requiring that the consideration for the restricted stock options (or restricted shares after exercise) be limited to options or shares of the acquirer that are subject to similar transfer restrictions.

Repurchase Conditions and Liability Accounting

As proposed, notwithstanding the transferability restrictions otherwise required, the Exchange Act Rule 12h-1(f)(1)(iv) would require 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.” Footnote 48 in the SEC’s proposing release elaborates on this requirement. Footnote 48 states, “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.” Thus, if applicable state law does not otherwise permit the issuer to impose the proposed transfer restrictions, an issuer would be required to provide the employee with a put option on both the compensatory stock options and underlying shares in order to qualify for the proposed exemption.

However, the existence of a put option could adversely affect the accounting for the employee stock options under SFAS 123(R). With respect to a put on the underlying shares, Paragraph 31 of SFAS 123(R) states:

> A puttable (or callable) share awarded to an employee as compensation shall 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*.

With respect to a put on the options, Paragraph 32 of SFAS 123(R), as amended by FSP 123R-4, states:

> 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 [18a] to settle the option or similar instrument by transferring cash or other assets. [18b]
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> [18a] A cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) would not meet condition (b) until it becomes probable that event will occur.
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> [18b] SEC registrants are required to consider the guidance in ASR 268. Under that guidance, options and similar instruments subject to mandatory redemption requirements or whose redemption is outside the control of the issuer are classified outside permanent equity.

Accordingly, if, as a condition of the exemption, the options and underlying shares must be puttable to the issuer, that issuer would be required to account for the award as a liability under SFAS 123(R). That is, the issuer would be required to record the award at fair value (or intrinsic value) and recognize subsequent changes in fair (or intrinsic) value through earnings. Alternatively, if only the underlying shares are puttable to the issuer, and provided the employee could not exercise the put within six months of the option's exercise date, the issuer still might be able to account for the award as equity, based on its grant date fair value and without subsequent remeasurement.

Therefore, when state law prohibits the imposition of the transfer restrictions otherwise required to obtain the exemption, we recommend that the SEC consider limiting the required put to the shares underlying the stock options (i.e., not require the options to be puttable). Further, we recommend that SEC not require the put on the underlying shares to be exercisable within six months of exercise of the related option. These provisions might allow a nonpublic company to still account for its exempt stock options as equity awards rather than liability awards under SFAS 123(R).

Right of First Refusal

When applicable state law prohibits the imposition of restrictions on transferability, it would seem that a put option on the underlying shares would not necessarily accomplish the SEC's stated objective of limiting the potential development of a market for those shares. While a put option would obligate the issuer to repurchase the shares from the employee, the put option would not necessarily restrict the employee from selling the shares to an unrelated third party.

In order to make it more likely that an employee would exercise the put option, we recommend that the SEC also require that the shares be subject to a "right of first refusal," to the extent permissible under applicable state law. Under generally accepted accounting principles, a right of first refusal based on a bona fide offer by a third party ordinarily is not considered an obligation or an option to repurchase. Therefore, providing the issuer a right of first refusal, in the event the employee considers a sale or transfer of the options or shares, should not adversely affect the issuer's accounting for stock options as an equity award under SFAS 123R, provided that it not probable that the issuer would repurchase the shares within six months of exercise of the related options.

Audited Financial Statement Requirements

As a condition of the proposed exemption from registration, Exchange Act Rule 12h-1(f)(1)(vii) would require a non-public issuer to provide optionholders with specified information, including the issuer's financial statements. As proposed, those financial statements would be the same as the financial statements required under Rule 701 of Regulation E, which provides a separate exemption from registration when a non-public company originally issues stock options under compensatory arrangements. In turn, Rule 701 refers to the financial statements of Part F/S of Form 1-A, which does not require audited financial statements unless an issuer has prepared them for other purposes. Otherwise, Part F/S of Form 1-A allows an issuer to provide two years of unaudited financial statements. Thus, the proposed exemption from registration would allow the issuer to provide unaudited financial statements to optionholders, unless audited financial statements are otherwise available.

The SEC has requested comment whether the proposed exemption should require the issuer to provide audited financial statements even if its does not otherwise prepare them. We see no compelling reason to require a nonpublic company to obtain audited financial statements solely as a condition of the proposed exemption. Instead, we concur that audited financial statements should be required to be provided to optionholders only if the issuer has obtained an audit for other purposes. As a practical matter, we expect that most non-public companies with the number of compensatory optionholders necessary to benefit from the proposed exemption are likely to already be obtaining audited financial statements for other business and financing purposes.

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We would be pleased to discuss our comments with the Commission or its staff at your convenience.

Very truly yours,

Ernst & Young LLP