BUSINESS LAW SECTION

THE STATE BAR OF CALIFORNIA

PLEASE RESPOND TO:
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BY FACSIMILE AND U.S. MAIL

Department of Corporations
1515 K Street, Suite 200
Sacramento, CA 95814-4017

Attention: Kathy Womack

Re: Proposed Amendments to 10 CCR §§260.102.19, 260.140.41, 260.140.42, 260.140.45 and 260.140.46

Ladies and Gentlemen:

The Corporations Committee of the Business Law Section of the State Bar of California (the "Committee") is writing to comment on the proposed amendments by the Commissioner of Corporations (the "Commissioner") to the above regulations (the "Proposed Amendments"). These regulations relate to the standards used for the exercise of discretion by the Commissioner in determining whether to qualify the offer and sale of securities under the Corporate Securities Law of 1968, Corporations Code Sections 25100 et. seq. (the "CSL"). Compliance with these rules is also required as a condition to the exemption from the provisions of Section 25110 set forth in Section 25102(o). The foregoing regulations as currently adopted are sometime referred to herein as the "Regulations."

Members of the Committee, as attorneys regularly advising California businesses, are aware of the desirability of clarifying and streamlining the requirements of the exemption afforded to corporations under Section 25102(o). The Committee believes that this matter is germane under the current standards adopted by the Board of Governors of the State Bar of California because (i) the matter requires special knowledge, training, experience or technical expertise

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with respect to Section 25102(o) and the Regulations, and (ii) the Committee's comments with respect to the Proposed Amendments will promote consistency, clarity and comprehensiveness in the law.

This letter is intended to generally support and expand upon the letter dated July 5, 2001 from Keith Bishop sent to the Department with respect to the Proposed Amendments. We believe that Mr. Bishop's letter is well-considered and we fully support Mr. Bishop's specific comments stated therein except as otherwise discussed below.[1]

As the Commissioner is undoubtedly aware, California is virtually alone in imposing substantive requirements on the issuance of equity securities pursuant to compensatory benefit plans above and beyond the limitations already imposed by Rule 701 adopted under the Securities Act of 1933, as amended. Based upon an informal survey conducted by a member of the Committee, only three other states impose very limited substantive restrictions on equity compensation plans as a condition of a state exemption.[2] In addition, nine states require that a copy of the plan be filed with the appropriate state agency prior to issuance of securities under the plan, and impose a waiting period. However, we understand that, as a practical matter, those states rarely, if ever, provide substantive comment on the terms of the filed plans. As a result, we believe that the California conditions put California at a competitive disadvantage in terms of attracting and retaining employers in this state. The minimum vesting requirements and the minimum exercise price requirements under the current Regulations in particular are the subject of consternation on the part of employers currently located in California or considering relocating to or hiring employees in California.

In addition, we believe that the regulations should be drafted so that an issuer will be able to craft an equity plan so as to have a high level of comfort that the plan is in compliance with the exemption. In that regard, among other sections, we would point to Section 260.140.1 (incorporated into the Regulations by reference), which is vague and ambiguous.

Because the primary focus of our Committee is on the laws and regulations specifically affecting corporations, we feel that comment on the Proposed Rules as they apply to limited liability companies (LLCs) is beyond our jurisdiction and expertise. Accordingly, our comments do not address interpretive difficulties of the Proposed Rules as they relate to LLCs.[3]

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[1] It should be noted in the interest of full disclosure that Mr. Bishop is a member of the Committee. However, Mr. Bishop's comments in his letter are solely his own, and were provided to the Department without input from the Committee.

[2] Arizona denies the exemption if any of the issuer's principals have been subject to certain court or regulatory proceedings (the so-called "bad boy" prohibition). Louisiana requires (i) that only employees be eligible for option grants under the plan, and (ii) that no consideration be paid upon the grant of options other than services. Oregon requires that the plan be "fair, just and equitable" but otherwise provides no specific restrictions. Although Oregon requires filing of the plan, our experience with Oregon has been that as a practical matter no review of the plan is undertaken and that the plan filing is treated like a notice filing.

[3] For example, it is not clear how "voting power" as used in Section 260.140.41(b) is to be interpreted in the case of an LLC issuer.

As noted above, we concur with the specific comments of Mr. Bishop's July 5 letter, except as follows:

Section 260.140.41. (Employee, Director, Manager and Consultant Options)

Subsection (b) [Exercise Price]:

We agree with Mr. Bishop that this subsection should be deleted in its entirety. Among other things, this subsection limits the exercise price of stock options to not less than 85% of the fair market value of the underlying stock. It would appear that the intent of this subsection is to protect an issuer's shareholders rather than its optionees. However, it should be recognized that an issuer may grant options with exercise prices of less than 85% of fair market value outside of a Section 25102(o) exempt plan in reliance upon another exemption such as Section 25102(f), and that the issuer's directors are in any event subject to a fiduciary duty to the shareholders not to issue securities for inadequate consideration. Thus, if the Department believes it important that the shareholders consent to the minimum exercise price allowable under a plan, this subsection should be revised to simply state that the minimum exercise price is required to be set forth in the plan (which plan requires shareholder approval pursuant to subsection (i)).

Subsection (h) [Plan Termination Date]:

We concur with Mr. Bishop's proposed language for this subsection, with the additional phrase "whichever is earlier" added at the end of the insert to provide greater clarity and further consistency with Internal Revenue Code Section 422(b)(2). Thus, subsection (h) would read as follows:

> Options must be granted within ten years from the date the plan or agreement is adopted or the plan or agreement is approved by the issuer's shareholders or members, whichever is earlier.

Subsection (i) [Shareholder Approval]:

We concur with Mr. Bishop's proposals to delete the requirement of rescission for any options exercised prior to shareholder approval. Since an issuer could grant options outside of an option plan pursuant to other available exemptions, and thus completely avoid the substantive limitations of 25102(o), this subsection does not appear to provide very comprehensive protection to an issuer's shareholders. In addition, the current rescission requirement does not appear to be solely directed at protection of optionees, as an across-the-board rescission requirement would be disadvantageous to an optionee where the value of the underlying shares had increased over the exercise price. Accordingly, we recommend that the requirement of shareholder approval within a twelve-month period be clarified to be a condition of the exemption rather than a required provision of the plan. Thus, in the event shareholder approval is not obtained within the requisite time period, the options and/or shares issued upon exercise of options should be viewed as not being exempt under 25102(o) but still eligible for exemption under other provisions of the CSL such as Section 25102(f). Even if no exemption is available in any specific situation, there does not appear to be any compelling rationale for optionees not having the same rescission rights as any other purchasers of non-exempt securities.

Subsection (k) [Repurchase Rights]:

We agree with Mr. Bishop's proposal that this subsection should be eliminated. In addition to the issues raised in Mr. Bishop's letter, there are accounting issues raised by the current repurchase requirements of this subsection. FASB Interpretation No. 44 ("FIN 44") discusses whether variable accounting is required for a stock option with a share repurchase feature. FIN 44 provides that variable accounting is not required for a stock option where the stated share repurchase price is equal to the fair market value of the shares at the date of repurchase and the shares are not "expected to be repurchased" within six months after the exercise of the option. It follows that a share repurchase feature will result in variable accounting treatment if the shares *are* "expected to be repurchased" within six months after option exercise or share issuance.

If an issuer repurchases shares from terminated employees and is required to comply with subsection (k) to complete such repurchase within 90 days of termination, it appears that variable accounting would be required for the stock option plan. There does not appear to be any way to comply with subsection (k) and avoid the adverse accounting consequences associated with variable accounting.

Subsection (l) [Voting Rights]:

As indicated above, we believe this subsection to be extremely vague and ambiguous. To the extent that the Regulations can be revised to provide certainty to issuers, it would be a vast improvement. We understand from discussions with the Department's staff in connection with permit applications submitted prior to the adoption of Section 25102(o) that this standard is primarily intended to prohibit the granting of options with respect to a class of nonvoting common stock. Accordingly, we propose that this subsection be restated in its entirety to provide as follows:

> Compliance with Section 260.140.1 of these rules regarding the voting rights of common stock; provided however, that a corporate issuer will be deemed to be in compliance with Section 260.140.1 if (i) the issuer has only one class or series of common stock, or (ii) where the issuer has more than one class or series of common stock, each share of all such classes or series of common stock has identical voting rights except as otherwise required by law.

Section 260.140.42. (Employee, Director and Consultant Purchases.)

Subsection (d) [Adjustments and Reclassifications]:

We concur with Mr. Bishop's proposal. We also recommend (as proposed by Mr. Bishop's comment on subsection 260.140.41(e) above) that "or series" be added immediately after "issuer's class" in the Proposed Amendments. This addition is needed to clarify that an adjustment or reclassification may effect a "series" of stock, not just a "class."

Subsection (e) [Plan Termination Date]:

As noted in our comment to subsection 260.140.41(h), we propose that this subsection (e) be amended to read as follows:

> Securities must be sold within 10 years from the date the plan or agreement is adopted or the plan or agreement is approved by the issuer's shareholders or members, whichever is earlier.

In conclusion, we respectfully urge the Commissioner to make the foregoing changes to the Proposed Rules as provided in Mr. Bishop's letter and as further modified by this letter.

Very truly yours,

Robert F. Stansell, Co-Chair
of the Corporations Committee

cc: Colleen Monahan, Esq.
Suzanne S. Graeser, Esq.