JONES DAY

SEPTEMBER 2007

CHANGES TO CALIFORNIA RULES RELATING TO EQUITY COMPENSATION PLANS

On July 9, 2007, the California Corporations Commissioner (the "Commissioner") approved, effective immediately, changes to regulations relating to compensatory benefit plans. These regulations apply to offers and sales of securities to employees, officers, directors, consultants, and certain other advisors in California by privately held companies, public companies not listed on a nationally recognized stock exchange, and foreign private issuers. The amendments to these regulations relax a number of substantive requirements applicable to these companies. Historically, California has heavily regulated the terms of equity grants and awards to service providers within California. Many companies that view equity awards as a key incentive for employees and other service providers have operations within California, making compliance with California law on equity compensatory plans a significant concern. Further, employers' interest in treating employees, in particular, consistently throughout the United States has meant that many of the terms mandated by California law have become prevalent in terms seen nationwide in equity awards by private companies. The changes adopted by the Commissioner significantly increase flexibility for employers granting equity-based awards to employees and other service providers within California, and they should have a widespread impact.

BACKGROUND

Section 25110 of the California Corporate Securities Law of 1968, as amended (the "California Securities Law"), generally prohibits the offer or sale of any security in California pursuant to an equity compensatory plan unless either the offer or the sale has been qualified by the Commissioner or an exemption is available. Most privately held companies adopting equity compensation plans and intending to offer participation to California employees rely primarily upon the exemption from qualification available under Section 25102(o) of the California Securities Law. Companies seeking to qualify plans for the Section 25102(o) exemption must comply not only with Rule 701 (promulgated under the

© 2007 Jones Day. All rights reserved. Printed in the USA.

Securities Act of 1933, as amended (the "Securities Act")), but with regulations promulgated by the Commissioner under Section 25102(o), which impose certain substantive requirements on the provisions of stock options and stock issuances such as restricted stock.

ADOPTED AMENDMENTS

The key changes resulting from the adopted amendments applying to equity compensation plans that qualify under the Section 25102(o) exemption from qualification under California state securities law are as follows:

- Expansion of the list of employees, officers, directors, consultants, and other advisors eligible to participate under a compensatory benefit plan, to conform to the eligibility requirements at the U.S. federal level of Rule 701 under the Securities Act.

- Elimination of the current potential limit on the total number of shares reserved for issuance under equity compensation plans if the plan otherwise complies with Rule 701 under the Securities Act. Previously, the number of securities issuable under the plan could not exceed 30 percent of the then outstanding number of shares, unless the right to exceed this limitation was approved by a two-thirds shareholder vote.

- Elimination of the requirement for a minimum option exercise price and minimum purchase price. Previously, stock options and restricted stock could not be granted with an exercise price less than 85 percent of the fair value of the stock at the time granted; for options and stock granted or awarded to a 10 percent shareholder, the exercise price could not be less than 110 percent of the value of the stock at the time the option was granted.

  Note: The removal of restrictions on the exercise price of options under the California Securities Law is likely not significant due to existing requirements of the Internal Revenue Code (the "Code") relating to deferred compensation and incentive stock options. Adverse tax consequences result to the holder of the option if options granted at less than fair market value do not comply with requirements of Code Section 409A. In addition, the grant of incentive stock options must comply with a number of requirements under Code Section 422, including that the incentive stock option may not be granted at less than fair market value of the stock on the date of the grant. The removal of the 85 percent limit on minimum purchase price, however, may be significant in certain instances where companies desire to structure discount purchases of restricted stock (which would not run afoul of 409A) to attract key executives.

- Elimination of the requirement that grants to rank-and-file employees must vest on a schedule of no less than 20 percent per year. *This change will give companies far greater flexibility in their option and share vesting terms*. Previously, an option to rank-and-file employees was required to provide the right to exercise at the rate of at least 20 percent per year from the date the option is granted, or, with respect to restricted stock, the restrictions were required to lapse at the rate of at least 20 percent per year, subject in each case to reasonable conditions such as continued employment.

- Elimination of the requirement that the company provide participants with financial statements on an annual basis. Companies must instead comply with the disclosure requirements of Rule 701.

SHAREHOLDER APPROVAL REQUIREMENTS

The plan or agreement must now be approved by a majority of the outstanding securities entitled to vote by the later of (a) 12 months after the date the plan is adopted or the agreement is entered into or (b) within 12 months of the date options or shares are granted under the plan or agreement, or the issuance of any other securities under the plan or agreement in California.

In addition, a foreign private issuer (as defined in Rule 3b-4 of the Securities Exchange Act of 1934, as amended) may grant options, shares, or other securities to up to 35 persons within California without receiving shareholder approval.

CONTINUING REQUIREMENTS

Following adoption of the amendments, the following substantive requirements remain:

- Grants must still generally qualify under Rule 701 to qualify under Section 25102(o).
- The plan must have a termination date of no more than 10 years from the date the plan is adopted or the plan is approved by shareholders, whichever is earlier, and an agreement termination date of no more than 10 years from the date the agreement is entered into or the date it is approved by shareholders, whichever is earlier. In addition, the exercise period of an option must not exceed 120 months from the date of grant.
- The plan must specify the total number of securities that may be issued and the class of individuals eligible to receive options and purchase securities under the plan.
- The number of securities and the exercise price subject to equity awards must be proportionately adjusted in the event of stock splits and similar transactions effected without the receipt of consideration by the issuer.
- Options and the right to acquire securities under the plan must be nontransferable, except as permitted by Rule 701 (by will, the laws of descent or distribution, or limited transfers to family members by gift or domestic relations orders permitted by Rule 701).
- The requirement of a minimum post-termination exercise period for options remains. Optionees must be permitted to exercise their options, to the extent that the optionee is entitled to exercise on the date employment terminates, until the earlier of (1) the option expiration date or (2) at least six months from a termination due to death or disability, and at least 30 days from a termination due to any other reason except cause.
- If a stock option or restricted stock is subject to repurchase rights in favor of the company following the termination of an optionee's or grantee's employment, the company must repurchase the option or shares within 90 days of termination or, in the case of securities issued upon post-termination exercise, within 90 days of the date of the exercise.

Companies may want to consult with their counsel to determine whether amendments to their existing 25102(o)-compliant equity compensation plans are advisable in order to take advantage of the now liberalized regulations.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Robert T. Clarkson
1.650.739.3996
rtclarkson@jonesday.com

Sarah Heck Griffin
1.213.243.2560
sgriffin@jonesday.com

Richard B. Meamber
1.650.739.3970
rmeamber@jonesday.com

Louis Rorimer
1.216.586.7224
lrorimer@jonesday.com

Esmé C. Smith
1.650.739.3929
ecsmith@jonesday.com

Diane L. Rose
(Blue-Sky Contact)
1.212.326.7808
dlrose@jonesday.com

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our web site at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.