CENTER FOR AUDIT QUALITY
Serving Investors, Public Company Auditors & the Markets

September 6, 2007

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

Dear Ms. Morris:

RE: File Number S7-14-07 Exemption of Compensatory Employee Stock Options from Registration under Section 12(g) of the Securities Exchange Act of 1934

The Center for Audit Quality (CAQ) is an autonomous public policy organization serving investors, public company auditors and the capital markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants. We welcome the opportunity to share our views on the Securities and Exchange Commission (SEC or the Commission), File Number S7-14-07, Release Number 34-56010, Exemption of Compensatory Employee Stock Options from Registration under Section 12(g) of the Securities Exchange Act of 1934 (the SEC Proposal).

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 Proposal 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, *Share-Based Payment* (''Statement No. 123R''). In our view, such restrictions generally should not affect the ability of a nonpublic company to value its stock options for purposes of Statement No. 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 pubic 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) allows 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." As drafted, the rule appears merely to allow the options and underlying shares to be puttable to the issuer if applicable state laws do not otherwise permit the issuer to impose the proposed transfer restrictions.

Footnote 48 in the SEC's proposing release also comments on this circumstance. 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." Footnote 48 appears to require that the options and underlying shares be puttable to the issuer if applicable state laws do not otherwise permit the issuer to impose the proposed transfer restrictions. We recommend that the SEC clarify the requirement in any final rule.

If the provision is intended to be required, the Commission should consider that 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.

> [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 and recognize subsequent changes in fair value through earnings. Alternatively, if only the underlying shares are puttable to the issuer at fair value, and provided the employee could not exercise the put within six months of the option's exercise date, the award could be accounted for as an equity award, based on its grant date fair value and without subsequent remeasurement.

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We appreciate the opportunity to comment on the SEC Proposal and would welcome the opportunity to meet with you to clarify any of our comments.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc: <u>SEC</u>
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