Private Companies Cannot Ignore SEC Registration Rules

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Registration of securities under the Securities Exchange Act of 1934 is something that many private companies have put out of their minds until the market improves. However, for private companies with over 500 stockholders or option holders, registration under the Exchange Act is a requirement, not a choice. The really bad news: registration under the Exchange Act creates public reporting obligations (10-K's, 10-Q's, etc.) without any public offering proceeds.

Private companies with more than 500 stockholders or more than 500 option holders may be required to register their stock or options under the Exchange Act. In addition, two private companies that are proposing to merge need to consider the applicability of the Exchange Act if the resulting company would end up with more than 500 stockholders or option holders.

Under Section 12(g) of the Exchange Act, a company with total assets in excess of $10 million and 500 or more record holders of a class of equity security, each measured at the end of its fiscal year, must register the class of equity security with the Securities and Exchange Commission, unless it has an exemption from such registration. Stock options are considered to be a separate class of equity security under the Exchange Act. Accordingly, a company with 500 or more option holders (including holders of unvested options) and more than $10 million in assets is required to register its stock options under the Exchange Act, absent an exemption.

The Commission has previously exempted companies with 500 or more option holders from having to register if the options (1) are not exercisable until the company's IPO or the seventh anniversary of the date of grant and (2) terminate or are cashed out upon the termination of the option holder's employment. These conditions were unpalatable to many companies for a variety of employee retention, accounting and state securities law reasons.

Earlier this year, the Commission modified these conditions in recognition of the fact that the plans of many companies to go public have been delayed because of market conditions. The Commission outlined five permitted modifications to the prior conditions for exemption from registration:

- Options may be immediately exercisable;
- Former employees may retain vested options;
- Consultants may participate in the option plan as long as they would be able to participate under Rule 701 of the Securities Act of 1933;
- Options may be transferable upon death or disability; and
- Stock received upon exercise of an option may not be transferable, except back to the company or in the event of death or disability.

In its announcement, the Commission stated: "We will premise any changes in our current position on option holders receiving essentially the same Exchange Act registration statement, annual report and quarterly report information they would have received had the company registered the class of securities under Section 12, including audited annual financial statements and unaudited quarterly financial information, each prepared in accordance with GAAP."

Although the Commission clearly intended to provide some relief to private companies with over 500 option holders, it is not clear how helpful most private companies will find the recent modifications, particularly in light of the requirement to provide essentially the same information that would be required if the company registered the stock options under the Exchange Act.

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