

FINAL STATEMENT OF REASONS  
FOR RULE CHANGES UNDER THE  
CORPORATE SECURITIES LAW OF 1968

As required by Section 11346.2 of the Government Code, the Commissioner of Corporations ("Commissioner") sets forth below the reasons for the proposed changes to Sections 260.102.19, 260.140.41, 260.140.42, 260.140.45, and 260.140.46 of the California Code of Regulations (10 C.C.R. §§ 260.102.19, 260.140.41, 260.140.42, 260.140.45, and 260.140.46).

Under the Corporate Securities Law of 1968 ("CSL"), the Commissioner of Corporations ("Commissioner") regulates the offer and sale of securities in California. Among other things, the Commissioner is charged with ensuring that the proposed plan of business of the issuer of securities, or the proposed issuance or sale of securities, is fair, just and equitable. Pursuant to this authority, existing regulations set forth standards for certain securities offerings intended to furnish guidelines in various situations for the exercise of the Commissioner's discretion to ensure the fairness of the transactions, among other things, based upon the usual or typical transactions encountered.

Among other types of transactions, the Commissioner has adopted regulations setting forth fairness standards for options granted to, and securities sold to, employees, directors, or consultants of the issuer of the securities (hereinafter the granting of options or selling of securities to employees, directors or consultants shall be referred to as "compensatory benefit plans"). (10 C.C.R. §§ 260.140.41 and 260.140.42.)

In addition to the regulations setting forth fairness standards for compensatory benefit plans, certain compensatory benefit plans are statutorily exempt from the requirement that the offer or sale of the securities be qualified under the provisions of the CSL. The offer or sale of securities issued pursuant to a compensatory benefit plan are exempt from qualification if the offering is exempt from registration under the federal Securities Act of 1933 pursuant to Rule 701 (17 C.F.R. § 230.701), and the terms of the compensatory benefit plan comply with the fairness standards for compensatory benefit plans set forth in the specified regulations. (Corporations Code § 25102(o).)

Compensatory benefit plans provided by limited liability companies

SB 1837 (Chap. 705, Stats. 2000) amended the provisions of the CSL which provide for the exemption from qualification for certain compensatory benefit plans, by expressly providing that the exemption from qualification applies to compensatory benefit plans offered by limited liability companies as well as corporations, and AB 1837 additionally removed references that limited the nature of the security to "stock." This legislation became effective January 1, 2001. Prior to this legislation, the exemption was solely applicable to a stock option plan or agreement, or a stock purchase plan or agreement, thereby limiting the exemption to corporations issuing stock.

SB 1837 continued the requirements in the CSL for securities offered pursuant to a compensatory benefit plan to be exempt from qualification, including that the offer or sale of securities must be exempt from registration under the federal Securities Act of 1933 pursuant to Rule 701, and that the terms of the compensatory benefit plan must comply with the fairness standards set forth in rules, as specified.

However, the existing rules setting forth the fairness standards for compensatory benefit plans describe the minimum requirements for corporations issuing shares of stock, thereby creating ambiguity regarding the standards necessary for a limited liability company issuing securities pursuant to a compensatory benefit plan. The proposed amendments to the rules resolve this ambiguity by amending the regulations to clarify that the same fairness standards apply for all types of securities issued under a compensatory benefit plan and for all types of issuers, not merely shares of stock issued by a corporation.

In Sections 260.140.41, 260.140.42, 260.140.45, and 260.140.46 of the California Code of Regulations, the references to “shares of stock,” “stock,” and “shares” are being changed to “securities,” and the references to “corporations” are being replaced with the term “issuer” or other appropriate term. These amendments are necessary to clarify the ambiguity created by SB 1837 (Chap. 705, Stats. 2000) regarding whether the fairness standards for the issuance of shares of stock pursuant to a compensatory benefit plan also apply to other types of securities issued pursuant a compensatory benefit plan. Also, “managers” are being added to the list of persons to whom option and purchase plans may be offered, in recognition of the management structure of limited liability companies.

#### Transferability of rights to purchase securities under a compensatory benefit plan

For option plans subject to Section 260.140.41 of the California Code of Regulations, options granted to employees, directors or consultants pursuant to a option plan or agreement are nontransferable other than by will, by the laws of descent and distribution, by instrument to an inter vivos or testamentary trust, or by gift to “immediate family,” as that term is defined in the Code of Federal Regulations. For purchase plans subject to Section 260.140.42 of the California Code of Regulations, the right to purchase securities under a purchase plan or agreement is also nontransferable, with a more limited number of exceptions. The right to purchase securities under a purchase plan or agreement is only transferable by will or the laws of descent and distribution.

In 1999, the federal Rule 701 regarding the exemption for offers and sales of securities pursuant to certain compensatory benefit plans was amended to expand the transferability of the securities. California’s rules on the non-transferability of securities issued pursuant to a compensatory benefit plan are being amended to allow transferability to the same extent as the federal rule, and provisions which are redundant to the federal rule are being removed.

## Notice of transaction under Section 25102(o) of the Corporations Code

For the exemption from qualification for certain compensatory benefit plan offerings to be perfected, the issuer must file a notice with the Commissioner not later than 30 days after the issuance of securities under the plan. The rule setting forth the notice to be filed is being amended to clarify that the notice must be filed not later than 30 days after the issuance of securities in California. The Department has found that requiring the notice to be filed in California not later than 30 days after the issuance of securities under the plan, regardless of whether any securities are offered at that time in California, is unduly burdensome on practitioners and may result in the Department imposing a notice filing requirement on a transaction that is outside the jurisdiction of the Department. Therefore, the amendment clarifies that the offer or sale must be in California to trigger the notice-filing requirement.

### Clarifications of rule

The proposed amendments to the rules further provide clarifications to existing rules on options and purchase plans, including clarifying that, where shareholder approval is required, the approval required is a majority of the outstanding securities entitled to vote, and clarifying that a compensatory benefit plan need only provide for the adjustment of the number of securities purchasable in the event of a distribution of securities, when no consideration is provided by the issuer.

### ALTERNATIVES CONSIDERED

No reasonable alternative considered by the Department or that has otherwise been identified and brought to the attention of the Department would be more effective in implementing the provisions of SB 1837 (Chap. 705, Stats. 2000) or would be as effective and less burdensome to affected private persons, than the proposed action.

### DETERMINATIONS

The Commissioner has made a determination that the proposed regulatory action does not impose a mandate on local agencies or school districts, which require reimbursement pursuant to Part 7 (commencing with Section 17500) of Division 4 of the Government Code.

The Commissioner has made a determination that the proposed regulatory action will not have a significant adverse economic impact on business based upon the language of SB 1837, which by its own operation requires limited liability companies to comply with specified sections of the California Code of Regulations in order to obtain the exemption from qualification provided by that legislation.

### ADENDUM REGARDING PUBLIC COMMENTS

No request for hearing was received during the 45-day public comment period which ended on August 13, 2001. No public hearing was scheduled or heard.

## COMMENTS RECEIVED DURING THE 45-DAY COMMENT PERIOD

COMMENTOR: Keith Bishop, by letter dated July 5, 2001.

COMMENT 1: The commentor notes that the Commissioner's Statement of Reasons for the 2001 Proposed Amendments does not cite any empirical or other study that justifies retention of any of the current rules. The commentor further states that retention of some of the existing standards conflicts with previous findings by the Commissioner in connection with amendments proposed in 1999 with respect to the same regulations (published in Cal. Reg. Notice Register 99, No. 01-Z, p. 26, hereinafter referred to as the "1999 Proposed Amendments"). The commentor encourages the Commissioner to review all future regulatory proposals with a view towards eliminating regulations that cannot be justified either analytically or empirically.

RESPONSE: While the Department's current rulemaking project is generally limited to implementing the statutory change to Section 25102(o) of the Corporations Code enacted by SB 1837 (Chap. 705, Stats. 2000) and the scope of the current rulemaking action does not include a review of the existing standards for the issuance of securities pursuant to an option or purchase plan or agreement, the Department notes the commentor's interest in having the Commissioner conduct a comprehensive review of all rules to which the Department proposes changes.

COMMENT 2. The commentor requests that Section 260.241.41 be amended to include officers, advisors and insurance agents who are employees for purposes of Rule 701(c) (17 C.F.R. § 230.701(c)) in the list of option grantees, and to remove the term "affiliate" for the grantor, but instead set forth the grantor as including the issuer's parents, its majority-owned subsidiaries or majority-owned subsidiaries of the issuer's parent. The commentor indicates that the term "affiliate" is not generally defined under the Commissioner's rules, whereas the terms "parent" and "majority-owned subsidiary" is defined in Rule 405 under the Securities Act of 1933 (17 C.F.R. § 405).

RESPONSE: It is the view of the Department that consideration of this suggestion is outside the scope of the proposed rulemaking (see, e.g., Government Code Section 11346.8(c)). However, pursuant to Section 11346(b) of the Government Code, the Department is currently seeking comments on whether Sections 260.140.41, 260.140.42, 260.140.45, and 260.140.46 of title 10 of the California Code of Regulations should be further modified beyond the changes proposed in this rulemaking, and all comments related to those sections are solicited for the purpose of a comprehensive review of those rules. In this manner, the Department will have the opportunity to consider comments proposing changes to rules that are outside the scope of the current rulemaking, while ensuring that the Department does not adopt

during this rulemaking action changes to the rules which the public and interested parties did not have notice of or the opportunity to comment on.

COMMENT 3. The commentor requests that subsection (a) of Section 260.140.41 be amended to eliminate the reference to Section 260.140.45, as was proposed by the Department in the 1999 Proposed Amendments. The commentor suggests that this change will allow issuers greater flexibility in determining the appropriate number of securities that may be issued under the plan or agreement. The commentor indicates that Rule 701(d) (17 C.F.R. § 230.701(d)) limits the amount of securities that may be offered or sold in reliance upon that rule, and that compliance with Rule 701 is a condition to the exemption under Section 25102(o). The commentor indicates that there appears to be no justification for multiple inconsistent standards.

RESPONSE. It is the view of the Department that consideration of this suggestion is outside the scope of the proposed rulemaking (see, e.g., Government Code Section 11346.8(c)). However, pursuant to Section 11346(b) of the Government Code, the Department is currently seeking comments on whether Sections 260.140.41, 260.140.42, 260.140.45, and 260.140.46 of title 10 of the California Code of Regulations should be further modified beyond the changes proposed in this rulemaking action, and all comments related to those sections are solicited for the purpose of a comprehensive review of those rules. In this manner, the Department will have the opportunity to consider comments proposing changes to rules that are outside the scope of the current rulemaking action, while ensuring that the Department does not adopt during this rulemaking action changes to the rules which the public and interested parties did not have notice of.

Nevertheless, the Department notes that while compliance with Rule 701 is necessary for an issuer to avail itself of the exemption from qualification in Corporations Code Section 25102(o), the standards for option plans set forth in Section 260.140.41 are not limited to issuances of securities in reliance upon the 25102(o) exemption. Therefore, any limitation on the amount of securities that may be offered or sold under Rule 701 does not necessarily mean that such standard is applicable to all offerings subject to Section 260.140.41.

Further, the limitations on the amount of securities that may be offered or sold under Rule 701 only applies to securities offered or sold in a 12 month period, whereas Section 260.140.45 limits the total number of securities issuable upon exercise of all outstanding options, as provided, to 30% of the then outstanding securities of the issuer. Thus, the rules are not equivalent in their protection of security holders against dilution of the security holders' economic interests and voting rights and the existence of limitations in Rule 701 does not necessarily justify elimination of Section 260.140.45.

In 1997, Section 260.140.45 was amended to provide greater flexibility to issuers by allowing the 30% limitation set forth in that rule to be amended to a higher percentage upon approval by at least two-thirds of the outstanding securities entitled to

vote. This provision was enacted to provide a balance between the security holders' interests and the issuer's interests. No evidence has been presented to establish that the 1997 amendment does not adequately balance the interests of security holders and issuers.

Finally, the 1999 Proposed Amendments were subsequently abandoned due to concerns that the proposed amendments may not be in the public interest and for the protection of investors, as is generally the standard for discretionary actions by the Commissioner (see, for example, Corporations Code Sections 25105 and 25610). Also, there were concerns that the initial findings may not have been based upon sufficient information (an empirical or other study) on the impact of stock option grants on existing stockholders, the dilution effect of such plans on both economic and voting power, and the reallocation of ownership in the issuer between existing security holders and management and employees.

The impact of stock option plans and other equity compensation plans is not without controversy. See, for example, the Securities and Exchange Commission's discussion of such plans in its proposed amendments to the disclosure requirements applicable to proxy statements and periodic reports, and the additional discussions on options in the articles and books cited in the footnotes therein, Securities Act Release No. 7944 (January 26, 2001), 66 FR 8732 (February 1, 2001). Therefore, the Department will need evidence that amendments to the qualification standards for option and purchase plans are in the public interest and for the protection of investors prior to making any such amendment.

COMMENT 4. The commentor recommends that, consistent with the Department's 1999 Proposed Amendments, subsection (b) of Section 260.140.41 be deleted in its entirety. The commentor notes that, as the Commissioner has previously noted, the elimination of this subsection will allow the issuer and prospective optionees to negotiate freely the exercise price of options by taking into account their respective goals, results and interests. In this regard, the commentor notes that stock options intended to qualify as incentive stock options under Section 422 of the Internal Revenue Code of 1986 must have an option exercise price that is not less than the fair market value of the stock at the time the option is granted (or at least 110% of the fair market value in the case of an optionee owning more than 10% of the total combined voting power).

RESPONSE. As indicated in the Department's Response to Comment 3, the amendments proposed in the Department's 1999 Proposed Amendments are outside the scope of the current proposed rulemaking action. However, as noted above, in light of the interest in further amendments to the rules on option and purchase plans beyond those proposed in this rulemaking action, the Department is seeking comments from interested persons on amending such rules further, and welcomes the commentor's suggestions through that forum.

COMMENT 5. The commentor indicates that the Commissioner's Statement of Reasons incorrectly states that under existing law options are nontransferable with certain exceptions. The commentor indicates that options granted in reliance upon an exemption other than Section 25102(o) are not subject to Section 260.140.41(d)'s provisions on transferability, and requests that the Statement of Reasons be clarified.

RESPONSE. The Department has clarified in the Final Statement of Reasons that options are nontransferable, except as provided, for securities subject to the rules on option and purchase plans.

COMMENT 6. The commentor recommends that "or series" be added immediately after "issuer's class" in Section 260.140.41(e).

RESPONSE. This Department finds that the proposed change is within the scope of the rulemaking action, and that the proposed change is necessary to clarify when an adjustment to the number of securities issued under an option plan is necessary. Accordingly, the final text has been amended.

COMMENT 7. The commentor recommends that subsection (f) of Section 260.140.41 be deleted, consistent with the 1999 Proposed Amendments. According to the commentor, as the Commissioner noted in the 1999 Proposed Amendments, repeal of the subsection will permit the issuer and its optionees to determine the exercise schedule that best suits their respective needs rather than a rigid and uniform state prescribed standard. The commentor indicates that an employer may want to tailor option vesting to the attainment of specific objectives by the employee, and the Commissioner's "one size fits all" approach effectively precludes the use of targeted incentives. The commentor states that in such instances, the employer may decide to forgo any option grant to an employees, and thus two unintended consequences of the current standard may be to deny employees the opportunity to receive stock options and to preclude employers from utilizing more specific, performance based criteria for determining when options become exercisable.

RESPONSE. As indicated in the Department's Response to Comment 3, the amendments proposed in the Department's 1999 Proposed Amendments are outside the scope of the current proposed rulemaking. However, as noted above, in light of the interest in further amendments to the rules on option and purchase plans beyond those proposed in this rulemaking action, the Department is seeking comments from interested persons on amending such rules further, and welcomes the commentor's suggestions through that forum.

Nevertheless, the Department notes that in 1997 subsection (f) of Section 260.140.41 was amended to allow for options granted to officers, directors or consultants of the issuer to become fully exercisable at any time established by the issuer, in order to allow issuers greater flexibility to craft the terms of officer, director and consultant options to meet the issuer's needs, such as the use of performance based

criteria for the exercise of options. No evidence has been presented to indicate that the 1997 amendment did not sufficiently address the issuer's need for performance-based vesting schedules while balancing the interests of the option grantees. Further, to eliminate the vesting restrictions for employees would allow provisions in plans that could "golden handcuff" employees with excessively long vesting schedules. Prior to amending this subsection to eliminate the vesting schedule, the Department would need evidence that employees have sufficient bargaining power and knowledge to circumvent issuers imposing unreasonably long vesting periods that may make the option grants illusory.

COMMENT 8. The commentor suggests that it is unclear why it would not be "fair, just, and equitable" for an issuer to sell securities under a plan or agreement with a term of more than ten years. The commentor further suggests that the 2001 Proposed Amendments are ambiguous with respect to an "agreement termination date." According to the commentor, the agreement may include provisions, such as confidentiality or arbitration clauses, that the parties would like to extend for more than ten years. The commentor believes that the intent of subsection (h) was to require that all options be granted within ten years (which the commentor provides is a requirement of incentive stock options under the Internal Revenue Code). The commentor provides that options granted in the tenth year after adoption continue to be subject to the terms of the plan notwithstanding the fact that the plan does not permit option grants after ten years. To enhance consistency, the commentor recommends that the section be conformed as closely as possible to the provisions of Section 422(b)(2) of the Internal Revenue Code. The commentor suggests that if the ten-year limitation is to be retained, subsection (h) should be amended to read as follows in its entirety:

Options must be granted 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.

RESPONSE. While the Department at this time has not identified any concerns with the commentor's proposal to eliminate the ten year plan termination requirement for option plans, the Department believes that the public should be provided notice and the opportunity to comment prior to the Department adopting such an amendment. Since the elimination of the ten year plan termination requirement for option plans was not provided to the public for comment, the Department will further consider this proposed change as part of its comprehensive review of the option and purchase plan rules described in the Response to Comment 3. With respect to the commentor's comment that the 2001 Proposed Amendments are ambiguous with respect to an "agreement termination date" because the agreement may include provisions, such as confidentiality or arbitration clauses, that the parties would like to extend for more than ten years, the Department disagrees that the parties' desire to have a longer term agreement is sufficient to make the proposed amendment ambiguous. Rather, it appears to make the rule on the agreement termination date undesirable in the instances described by the commentor.



Since the proposed amendments adding the “agreement termination date” is intended to clarify how an issuer is to avail itself of the exemption in Corporations Code Section 25102(o) which provides an exemption from qualification for option plans or agreements that comply with the terms of Rule 260.140.41, the Department finds that the proposed amendment is necessary to conform the exemption to the language of the rule.

COMMENT 9. The commentor recommends that, to minimize ambiguity, subsection (i) of Section 260.140.41 utilize the statutory terminology applicable to corporations and limited liability companies. Further, the commentor indicates that it is the commentor’s understanding that for financial reporting purposes option grants subject to later shareholder approval have a “measurement date” only when shareholder approval is obtained (unless approval is assured because of the concentration of share ownership). The commentor indicates that this can cause a company to incur dramatically higher compensation expenses when its stock value increases between the option grant date and shareholder approval. For example, a company may adopt, subject to shareholder approval, an option plan and grant options with exercise prices at the then fair market value of \$10 per share. If at the time of shareholder approval the fair market value has increased to \$20 per share, the \$10 difference will be accounted for as a compensation expense. This compensation expense, which does not affect cash, can prevent or delay planned future financing and the future growth of the company. Thus, an unintended consequence of the Commissioner’s standard is to require in many cases adverse accounting consequences.

The commentor recommends that the subsection be amended to read as follows:

Approval by the outstanding shares (as defined in Section 152 of the Corporations Code) in the case of an issuer that is a corporation or approval by a majority in interest of the members (as defined in Section 17001(v) of the Corporations Code) in the case of an issuer that is a limited liability company within 12 months before or after the date on which the plan or agreement is adopted or entered into. Any shares issued pursuant to an option exercised prior to such approval shall not be counted in determining whether such approval is obtained.

RESPONSE. The Department has decided not to use the statutory terminology applicable to corporations and limited liability companies for two reasons. First, while the qualification exemption in Corporations Code 25102(o) is only available to corporations and limited liability companies, the option plan standards in Rule 260.140.41 do not have a similar restriction, and thus the proposed language would be too limiting. Second, the referenced code sections may cause confusion on how to achieve security holder approval. Nevertheless, the Department is willing to consider what security holder approval of a plan is adequate during the Department’s comprehensive review of the rules described in the Response to Comment 3, and seeks additional comments on this issue.

With respect to the commentor's proposal to eliminate the provision requiring rescission of options exercised before security approval is obtained, it is the Department's view that such a change is outside the scope of the current proposed rulemaking. However, as noted in the Response to Comment 3, in light of the interest in further amendments to the rules on option and purchase plans beyond those proposed in this rulemaking action, the Department is seeking comments from interested persons on amending such rules further, and welcomes the commentor's suggestions through that forum.

COMMENT 10. Commentor recommends that, consistent with the 1999 Proposed Amendments, subsection (k) of Rule 260.140.41 should be deleted. Commentor states that, as the Commissioner noted in the 1999 Proposed Amendments, repeal of subsection (k) will permit issuers and optionees to negotiate the terms of repurchase, including price, prior to or during the course of employment and will relieve companies of the obligation and cost of guaranteeing the value of employee shares.

RESPONSE. As indicated in the Department's Response to Comment 3, the amendments proposed in the Department's 1999 Proposed Amendments are outside the scope of the current proposed rulemaking. However, as noted above, in light of the interest in further amendments to the rules on option and purchase plans beyond those proposed in this rulemaking action, the Department is seeking comments from interested persons on amending such rules further, and welcomes the commentor's suggestions through that forum.

Nevertheless, the Department notes that eliminating subsection (k) of Rule 260.140.41 may arguably provide the issuer with an unfair bargaining advantage in negotiating the repurchase price for securities upon the termination of employment, because (1) the issuer is in a better position to have inside knowledge on the value of the security, and (2) the optionee may not have access to any market that may exist for the securities outside of the issuer.

COMMENT 11. The commentor recommends that subsection (l) of Section 260.240.41 be made applicable only to shares of common stock of a corporation and not extended to memberships and other interests in limited liability companies. The commentor indicates that the limited liability company is intended to be a very flexible structure with respect to the management of the entity, in contrast to the more rigidly prescribed management structure of a corporation. The commentor states that the reference to "similar equity securities" will undoubtedly cause a great deal of confusion in the context of limited liability companies.

RESPONSE. Section 260.240.41(l) required compliance with Section 260.140.1 of the rules before the Department's proposed amendments. Section 260.140.1 provides that common share and similar equity securities should normally carry equal voting rights on all matters where such vote is permitted by applicable law, and this

standard has existed since rules were first adopted under the CSL more than 30 years ago. The reference to “similar equity securities” in the proposed regulation is conforming language to existing language in Section 260.140.1.

Perhaps the commentor may be construing the proposed language as requiring limited liability company membership interests to have voting rights if they are subject to an option plan. However, the language only requires such membership interests to have voting rights if similar membership interests have voting rights. If no membership interests have voting rights, then the membership interests for which the options are granted would not be required to have voting rights pursuant to the provision.

COMMENT 12. The commentor recommends that the introductory clause to Section 260.140.42 be amended to read as follows, for the reasons set forth in Comment 2:

Securities sold to employees (including insurance agents who are employees for purposes of Rule 701(c) under the Securities Act of 1933, as amended (17 CFR 230.701)), directors, managers, advisors or consultants of the issuing corporation issuer, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of the issuer's parents, shall be pursuant to a plan or agreement that provides for all of the following:

RESPONSE: For the same reasons set forth in the Response to Comment 2, the Department is not amending the rule as proposed by the commentor. However, as noted above, in light of the interest in further amendments to the rules on option and purchase plans beyond those proposed in this rulemaking action, the Department is seeking comments from interested persons on amending such rules further, and welcomes the commentor's suggestions through that forum.

COMMENT 13: The commentor recommends that, consistent with the Commissioner's 1999 proposed amendments, subsection (a) of Section 260.140.42 be amended to permit the agreement to express the number of securities as a fixed number or percentage. The commentor recommends that subsection (a) be amended to read in its entirety as follows:

The total number, or percentage, of ~~shares~~ securities which may be issued and the persons eligible to purchase ~~shares~~ securities under the plan or agreement.

RESPONSE: While the Department has not identified any concerns with the proposed language at this time, the Department believes that the public should be provided notice and the opportunity to comment prior to the Department adopting such an amendment. Since the commentor's proposed language was not provided to the public for comment, the Department will further consider this proposed change as part of its comprehensive review of the option and purchase plan rules described in the Response to Comment 3.

COMMENT 14. The commentor recommends that, consistent with the Commissioner's 1999 proposed amendments, subsection (b) of Section 260.140.42 be deleted.

RESPONSE. For the same reasons set forth in the Response to Comment 4, the Department is not amending the rule as proposed by the commentor. However, as noted above, in light of the interest in further amendments to the rules on option and purchase plans beyond those proposed in this rulemaking action, the Department is seeking comments from interested persons on amending such rules further, and welcomes the commentor's suggestions through that forum.

COMMENT 15. The commentor recommends that, consistent with Rule 701, "advisor" be added to subsection (c) of Section 260.140.42.

RESPONSE. For the same reasons set forth in the Response to Comment 2, the Department is not amending the rule as proposed by the commentor. However, as noted above, in light of the interest in further amendments to the rules on option and purchase plans beyond those proposed in this rulemaking action, the Department is seeking comments from interested persons on amending such rules further, and welcomes the commentor's suggestions through that forum.

COMMENT 16. The commentor recommends that, consistent with Rule 701 and SB 1837, "advisor" and "manager" be added to subsection (d) of Section 260.140.42.

RESPONSE. With respect to the addition of the term "manager," the Department agrees with the commentor that such addition is necessary to implement SB 1837, and believes that the public was adequately noticed that such a change could result from the proposed rulemaking action. Therefore, the Department has amended the Final Text to incorporate the change. With respect to the addition of the term "adviser," the Department is of the view that the proposed language is outside the scope of this rulemaking project, as explained in Response to Comment 2, and is not amending the rule as proposed by the commentor.

COMMENT 17. With respect to subsection (e) of Section 260.140.42, the commentor indicates that there may be valid reasons for many provisions of a plan or agreement to remain effective for a longer time. If a ten-year limitation is to be retained, the commentor recommends that subsection (e) be amended to read in its entirety 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.

RESPONSE. For the same reasons set forth in the Response to Comment 8, the Department is not amending the rule as proposed by the commentor. However, as

noted above, in light of the interest in further amendments to the rules on option and purchase plans beyond those proposed in this rulemaking action, the Department is seeking comments from interested persons on amending such rules further, and welcomes the commentor's suggestions through that forum.

COMMENT 18. The commentor recommends that, for the reasons set forth in COMMENT 9, subsection (f) of Section 260.140.42 be amended to read in its entirety as follows:

Approval by the outstanding share (as defined in Section 152 of the Corporations Code) in the case of an issuer that is a corporation or approval by a majority in interest of the members (as defined in Section 17001(v) of the Corporations Code) in the case of an issuer that is a limited liability company within 12 months before or after the date the plan or agreement is adopted or entered into. Any security issued under the plan or agreement prior to such approval shall not be counted in determining whether such approval is obtained.

RESPONSE. For the same reasons set forth in Response to Comment 9, the Department is not amending the rule as proposed by the commentor. However, as noted above, in light of the interest in further amendments to the rules on option and purchase plans beyond those proposed in this rulemaking action, the Department is seeking comments from interested persons on amending such rules further, and welcomes the commentor's suggestions through that forum.

COMMENT 19. The commentor recommends that, for the reasons set forth in COMMENT 10, subsection (h) of Section 260.140.42 be deleted in its entirety.

RESPONSE. For the same reasons set forth in Response to Comment 10, the Department is not amending the rule as proposed by the commentor. However, as noted above, in light of the interest in further amendments to the rules on option and purchase plans beyond those proposed in this rulemaking action, the Department is seeking comments from interested persons on amending such rules further, and welcomes the commentor's suggestions through that forum.

COMMENT 20. The commentor recommends that, consistent with the Commissioner's 1999 proposed amendments, Rule 260.140.45 be deleted. The commentor states that plans and agreements under Rules 260.140.41 and 260.140.42 are subject to shareholder or member approval. The commentor further indicates that plans or agreements must satisfy the conditions to Rule 701 which includes a limitation on the amount that may be sold in reliance upon that rule.

RESPONSE. For the same reasons set forth in Response to Comment 3, the Department is not amending the rule as proposed by the commentor. However, as noted above, in light of the interest in further amendments to the rules on option and purchase plans beyond those proposed in this rulemaking action, the Department is

seeking comments from interested persons on amending such rules further, and welcomes the commentor's suggestions through that forum.

COMMENT 21. The commentor strongly urges the Commissioner to make changes that are (1) consistent with existing federal regulations; and (2) consistent with the Commissioner's own 1999 proposed amendments.

RESPONSE. The amendments proposed in the Department's 1999 Proposed Amendments are outside the scope of the current proposed rulemaking, and the adoption of the commentor's proposed change would deny the public the opportunity to have notice of, and provide comments on, the proposed change prior to its adoption. However, as noted above, in light of the interest in further amendments to the rules on option and purchase plans beyond those proposed in this rulemaking action, the Department is seeking comments from interested persons on amending such rules further, and welcomes the commentor's suggestions through that forum.

COMMENTOR. Lee R. Petillon, Petillon & Hansen, by letter dated July 13, 2001.

COMMENT 22. The commentor endorses the recommendations in Mr. Bishop's July 5, 2001 letter.

RESPONSE. Mr. Bishop's comments are addressed in COMMENT 1 through 21, and the accompanying responses.

COMMENTOR: William D. Evers, Foley & Lardner, by letter dated July 31, 2001.

COMMENT 23. The commentor is in accord with the comments of Mr. Bishop's July 5, 2001 letter.

RESPONSE. Mr. Bishop's comments are addressed in COMMENT 1 through 21, and the accompanying responses.

COMMENTOR. The Corporations Committee of the Business Law Section of the State Bar of California, Robert F. Stansell, Co-Chair of the Corporations Committee, writing on its behalf, by letter dated August 13, 2001.

COMMENT 24. The commentor concurs with the specific comments of Mr. Bishop's July 5<sup>th</sup> letter, except as noted in other comments.

RESPONSE. Mr. Bishop's comments are addressed in COMMENT 1 through 21, and the accompanying responses.

COMMENT 25. The commentor indicates that Section 260.140.1 (incorporated by reference into the current regulations) is vague and ambiguous.

RESPONSE. As indicated in Response to Comment 11, Section 260.140.1 has been the existing standard for the qualification of securities for over 30 years, and currently is not proposed to be amended. Nevertheless, as noted above, in light of the interest in further amendments to the rules on option and purchase plans beyond those proposed in this rulemaking action, the Department is seeking comments from interested persons on amending such rules further. To the extent that Section 260.140.1 is incorporated by reference into the rules on option and purchase plans, the commentor's concerns and suggestions are welcome through that forum.

COMMENT 26. The commentor indicates that the primary focus of the Corporations Committee is on the laws and regulations specifically affecting corporations, and indicates that comments on the 2001 Proposed Amendments as they apply to limited liability companies is beyond the jurisdiction and expertise of the Committee.

RESPONSE. The 2001 Proposed Amendments are intended to primarily amend provisions of the option and purchase plan rules to allow a limited liability company to claim the exemption in Corporations Code 25102(o) enacted by SB 1837 (Chap. 705, Stats. 2000). Comments on the existing rules on option and purchase plans that are beyond the changes being proposed in the current rulemaking action are outside the scope of this rulemaking action. However, as noted above, in light of the interest in further amendments to the rules on option and purchase plans beyond those proposed in this rulemaking action, the Department is seeking comments from interested persons on amending such rules further, and welcomes the commentor's suggestions through that forum.

COMMENT 27. The commentor (1) expands on Mr. Bishop's comments on eliminating subsection (b) of 260.140.41, as provided, (2) provides additional phrasing to Mr. Bishop's recommendation on subsection (h) of Section 260.140.41, (3) expands on Mr. Bishop's proposal to delete the rescission requirement under subsection (l) of Section 260.140.41, (4) expands on Mr. Bishop's proposal to eliminate subsection (k) of Section 260.140.41, (5) requests that subsection (l) be revised to provide certainty to issuers, (6) requests that "or series" be added to the amendments to subsection (d) of Section 260.140.42, and (7) requests that subsection (e) of Section 260.140.42 be amended similar to that proposed by the commentor for subsection (h) of Section 260.140.41.

RESPONSE. In general, the comments that are outside the scope of the current proposed rulemaking. However, as noted above, in light of the interest in further amendments to the rules on option and purchase plans beyond those proposed in this rulemaking action, the Department is seeking comments from interested persons on amending such rules further, and welcomes the commentor's suggestions through that forum. The commentor's suggestion regarding subsection (l) of Section 260.140.41 is further addressed in Response to Comment 25. The commentor's suggestion regarding subsection (e) of Section 260.140.42 may be addressed during the Department's

subsequent action seeking comments from interested persons on amending these rules further.

COMMENTER. William D. Evers, Foley & Lardner, by letter dated July 31, 2001.

COMMENT 28. The commentor indicates that he is in accord with each and every one of Mr. Bishop's July 5, 2001 letter, and urges the Commissioner to make every effort to allow California companies (including limited liability companies) to have as much flexibility as possible in the granting and terms of any option and purchase plans.

RESPONSE. The commentor's opinion is noted. Mr. Bishop's comments are addressed in COMMENT 1 through 21, and the accompanying responses. As noted above, the Department is currently seeking comments from interested persons on amending the existing rules on option and purchase plans further than in this rulemaking action, and the Department welcomes the commentor's suggestions through that forum, to the extent that any comments from Mr. Bishop's July 5, 2001 letter are outside the scope of the current rulemaking project.

No other comments were received during the 45-day public comment period.

#### COMMENTS RECEIVED AFTER THE 45-DAY COMMENT PERIOD

COMMENTORS: Mark G. Heesen, Vice President, National Venture Capital Association, by letter dated October 3, 2001; Louis M. Castruccio, by letter dated October 8, 2001; Paul A. Rowe, Hewitt & O'Neil LLP, by letter dated October 17, 2001; and William L. Twomey, Hewitt & O'Neil LLP, by letter dated November 27, 2001.

COMMENTS: In general, the commentors expressed support for Mr. Bishop's July 5, 2001 letter, as posted on The Corporate Lawyer website or otherwise provided to the commentors.

RESPONSE: Mr. Bishop's comments are addressed in COMMENT 1 through 21, and the accompanying responses.

#### COMMENTS RECEIVED DURING THE SUBSEQUENT 15-DAY COMMENT PERIOD

The 15-day comment period ended on December 21, 2001. No comments were received during this 15-day comment period.

#### COMMENTS RECEIVED AFTER THE SUBSEQUENT 15-DAY COMMENT PERIOD

COMMENTOR: Kirk Maldonado, by email dated December 26, 2001.

COMMENT: The commentor expressed support for Mr. Bishop's July 5, 2001 letter.



RESPONSE: Mr. Bishop's comments are addressed in COMMENT 1 through 21, and the accompanying responses.