SEC TIGHTENS ACCOUNTING FOR "SPRING-LOADED" EQUITY AWARDS

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Spring-loading – awarding equity awards before announcing material good news – was in the headlines 15 years ago but still surfaces on occasion, notably when in July 2020 Kodak made large grants to executives the day before a major announcement. On November 29, 2021, the SEC announced the issuance of Staff Accounting Bulletin No. 120 addressing how companies should properly recognize and disclose compensation costs for "spring-loaded awards" made to executives.

During the height of the option backdating scandals in 2006, the SEC chief accountant issued guidance on measurement dates and compensation expense, including an explicit direction to use "unadjusted" stock prices, without regard to any material nonpublic information:

> "Some companies appear to have engaged in techniques to select their award dates in coordination with the disclosure of information to the public. For example, a company may have granted stock options while it knew of material non-public information that was likely to result in an increase to the stock price. Alternatively, a company may have delayed the grant of options until after material information that was expected to result in a decrease to the stock price was issued. To the extent such practices were used, questions have been raised as to whether an adjustment would be necessary to the market price of the stock at the measurement date for the purpose of measuring compensation cost. Pursuant to paragraph 10(a) of Opinion 25, the staff believes that compensation cost must be computed on the measurement date by reference to the unadjusted market price of a share of stock of the same class that trades freely in an established market."

Some commentators criticized that practice as permitting abuse, but the SEC staff then believed that "'[t]he accounting for those kind of options is clear. We felt our hands were tied."

According to the Wall Street Journal, "[s]ome top executives in recent years have manipulated stock prices to increase their option compensation, including through spring loading and other awards practices, according to academic research by three finance professors published last year tracking 1,500 publicly traded companies from 2007 to 2012."

New Staff Guidance. In a sharp change in direction – primarily with respect to "non-routine" equity grants – the new guidance calls for considering whether, in measuring compensation cost, to adjust market prices in light of material non-public good news to be announced shortly after the grant date, stating:

> "The staff has observed numerous instances where companies have granted share-based compensation while in possession of positive material non-public information, including share-based payment transactions that are commonly referred to as being "spring-loaded." When companies are in possession of positive material non-public information, the staff believes these companies should consider whether adjustments to the current price of the underlying share or the expected volatility of the price of the underlying share for the expected term of the share-based payment award are appropriate when applying a fair-value-based measurement method to estimate the cost of its share-based payment transactions."

Key points made by the staff include:

- Adjustments to observable market prices (e.g., the closing share price or the share price at another specified time) "may be required, for example, when the observable market price does not reflect certain material non-public information known to the company but unavailable to marketplace participants at the time the market price is observed."

- Although companies typically have non-public information when making awards, the staff believes that grant date stock prices are "generally a reasonable and supportable estimate of the current price of the underlying share in a share-based payment transaction, for example, when estimating the grant-date fair value of a routine annual grant to employees that is not designed to be spring-loaded."

- "However, companies should carefully consider whether an adjustment to the observable market price is required, for example, when share-based payments arrangements are entered into in contemplation of or shortly before a planned release of material non-public information, and such information is expected to result in a material increase in share price. The staff believes that non-routine spring-loaded grants merit particular scrutiny by those charged with compensation and financial reporting governance."

- "Additionally, when a company has a planned release of material non-public information within a short period of time after the measurement date of a share-based payment," the staff believes a material stock price increase upon the release of such information "indicates marketplace participants would have considered an adjustment to the observable market price on the measurement date to determine the current price of the underlying share."

Other Topics. The new guidance also addresses a number of aspects of accounting for equity awards, including:

- Methodologies when transitioning from private to public company status
- Valuation techniques or models for fair value measurement
- Considerations when estimating expected volatility and expected contractual terms of awards, including material non-public information
- Disclosures in financial statements or MD&A
- Awards with redemption features that require settlement by cash or other assets upon events outside the control of the issuer

Recommendations. In view of this new guidance and with respect to equity award practices generally, companies should:

- Evaluate their controls and procedures related to equity award practices
  - Coordinate with accounting staff on documentation requirements in light of the new guidance

- Consider whether to adopt or revise policies relating to timing of grants in relation to material announcements
  - Although the new guidance focuses “primarily” on non-routine awards, some companies have previously adopted policies calling for awards to be granted, or to become effective, only during open windows, such as after earnings or other material announcements
  - Seek guidance from auditors as to any concerns if routine grants may be made outside window periods
  - Regularize and limit the number of grant dates (even for new hires), ideally using a long-established schedule for annual grants

- Consider SEC disclosure requirements, including:
  - The fair value of each equity award, in a column of the stock-based award table next to the base price (or, if lower, the closing market price)
  - The date the board or committee met to grant the award, if different from the grant date
  - The “methodology used to determine the exercise price if . .. [it] is not the closing price per share on the grant date”
  - The company’s granting policies, including “[h]ow the determination is made as to when awards are granted, including awards of equity-based compensation such as options”

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