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September 21, 2021

FASB Proposes Amendments to Address Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions

[33782]

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TO: ICI Members
Accounting/Treasurers Committee
Security Valuation Operations Committee SUBJECTS: Fund Accounting & Financial Reporting
Valuation RE: FASB Proposes Amendments to Address Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions

The Financial Accounting Standards Board (FASB) recently released an exposure draft of a proposed accounting standards update that would amend ASC Topic 820, Fair Value Measurement.[1] The proposed amendments address the fair value of equity securities that are registered for trading with regulatory authorities but are subject to contractual restrictions on resale (e.g., an underwriter lock-up agreement or market standoff agreement). Under the proposal, where the issuer of the equity security subject to the contractual restriction has identical equity securities that are registered and trading on a national securities exchange, the fair value of the equity security subject to the lock-up should be measured on the basis of the market price of the same equity security without the contractual sale restriction and should not be adjusted to reflect the reporting entity's inability to sell the equity security on the measurement date. The exposure draft includes transition guidance specific to investment companies intended to ensure that any change in fair value attributable to the proposed amendments does not affect net asset value at adoption. Comments on the exposure draft are due to the FASB by November 14, 2021.

Background

In 2020 the FASB received an agenda request to address the fair value of equity securities subject to underwriter lock-up agreements.[2] The agenda request noted there is diversity in practice on whether an underwriter lock-up should be considered in measuring the security's fair value. Some practitioners apply a discount to the price of an equity security if the issuer has an identical equity security that is freely traded, while other practitioners consider the application of a discount to be inappropriate under the principles of Topic 820.

The FASB decided it would be arbitrary to limit the scope of the project to underwriter lock-up agreements while not addressing other transactions that use similar contractual sale restrictions. Accordingly, the exposure draft addresses equity securities subject to contractual sale restrictions used in other capital raising transactions, including private investments in public equity (PIPEs) or a business combination involving a special purpose acquisition company (SPAC). The exposure draft is intended to reduce diversity in practice and improve comparability.

Proposed Amendments

The proposed amendments would modify the implementation guidance at Topic 820-10-55. Specifically, Case A at 820-10-55-52 currently addresses the fair value of an equity instrument that is legally or contractually restricted for a specified period and indicates that the fair value of the equity instrument would be measured on the basis of the quoted price for an otherwise identical unrestricted equity instrument of the same issuer that trades on a public market, adjusted to reflect the effect of the restriction. The proposed amendments strike the existing implementation guidance and substitute two separate examples: one addressing a legally restricted equity security, and one addressing an equity security that is not legally restricted but is subject to a contractual restriction on resale (e.g., an underwrite lock-up agreement).

The first example indicates that a market participant would consider the inability to resell the restricted security in a national securities exchange when pricing the equity security and that the restriction is a characteristic of the asset. In that case, the reporting entity should measure the fair value of the restricted security on the basis of the market price of the similar unrestricted equity security adjusted to reflect the effect of the restriction.

The second example indicates that the contractual restriction (e.g., an underwriter lock-up agreement) is not a characteristic of the asset and is ignored. The fair value of the equity security subject to the contractual restriction should be measured on the basis of the market price of the same equity security without the contractual sale restriction and should not be adjusted to reflect the reporting entity's inability to sell the equity security on the measurement date. That is, the contractual restriction on resale is a characteristic of the reporting entity holding the equity security rather than a characteristic of the asset.

The proposed amendments would add a new term "restricted security" to the master glossary. A restricted security would be defined as follows:

An equity security that is not registered for sale with a national securities exchange or an over-the-counter market, either domestic or foreign, when other equity securities from the same class of stock are registered for sale with a national securities exchange or an over-the-counter market. To be legally sold on national securities exchange or an over-the-counter market, the unregistered security must be registered or satisfy the conditions necessary for an exemption from registration. An equity security is no longer considered a restricted security if the conditions necessary for an exemption from registration have been met even if the security remains unregistered.

Transition and Effective Date

Entities that are investment companies under Topic 946 would apply the guidance on a prospective basis where the contractual restriction that prohibits sale is executed or modified on or after the date at which the investment company first applies the proposal.

For equity securities where the contractual restriction on sale was entered into before the date at which the fund first applies the guidance, the fund would continue to apply its existing accounting policy until the contractual restriction expires or is modified (i.e., equity securities subject to contractual restrictions where the contractual restriction was entered into before the date of adoption are "grandfathered").

The proposal indicates that the effective date will be determined after the Board considers stakeholder feedback.

Alternative Views

Three of the seven Board members did not support the conclusion in the proposal that would preclude all entities from incorporating the effects of an entity-specific contractual sale restriction in determining fair value. These Board members believe the proposal would systematically overstate the fair value of equity securities subject to contractual restrictions on sale. They note the valuation of securities directly affects the price at which the shares of investment companies are sold to or redeemed from individual investors. In addition to causing an overstatement of net asset value, these Board members noted the proposal has the potential to result in excess compensation to the investment manager and may result in less meaningful reporting of investment company performance.

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endnotes

[1] The exposure draft, Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions, File Reference No. 2021-005 (September 15, 2021), is available on the FASB website.

[2] See, e.g., letter from Ernst & Young LLP to Susan Cosper, Chair of the Emerging Issues Task Force (March 20, 2020).