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Agenda request – valuing a security subject to a separate underwriter agreement to restrict the sale of the security for a specified period

Dear Ms. Cosper,

Ernst & Young LLP appreciates the opportunity to submit an agenda request to the Emerging Issues Task Force (EITF). We request that the EITF address the application of Accounting Standards Codification (ASC) 820, Fair Value Measurement, when valuing a security subject to a separate underwriter agreement to restrict the sale of the security for a specified period (i.e., an underwriter lockup agreement).

We are making this request because we believe entities have reached different conclusions when evaluating the guidance in ASC 820-10-35-2B and 35-2C to determine whether a market participant would take a restriction created by a contractual underwriter agreement into account when valuing the post-initial public offering (IPO) common shares. That is, entities may reach different conclusions on whether the restriction is a characteristic of the share or an entity-specific restriction. We believe there is an opportunity to increase consistency in this area. While our request is related to the application of the guidance to underwriter lockup restrictions, a clarification of this guidance could affect considerations of restrictions more broadly.

Upon the completion of an IPO, the pre-IPO shareholders of a company (referred to as reporting entities herein) typically retain a significant investment in the investee company in the form of the investee's publicly traded common shares. The sale of those shares following the IPO may be subject to an underwriter lockup agreement. Underwriter lockup agreements prevent or limit sales of the shares subject to the agreement for a specified period (typically 180 days) and can take different legal forms. US securities laws do not require the use of lockup agreements; however, some states require lockup agreements under their "blue-sky" laws. All details included in the lockup agreements must be outlined in the registration documents the company files as part of the IPO process, including in its prospectus.

If a reporting entity holds a position in a single asset, including a large number of identical assets, such as shares, and the asset is traded in a public market stock exchange, the fair value of the share is generally measured within Level 1 of the fair value hierarchy as the product of the quoted price of the individual share and the quantity held by the reporting entity (i.e., P*Q) following the guidance in ASC 820-10-35-44. However, a reporting entity is also required to evaluate any legal or contractual restrictions on the share to determine whether the share contains any restrictions that would be taken into account by a market participant (i.e., considered a characteristic of the share and not an entity-specific restriction). If a reporting entity determines that a restriction is a characteristic of the share, an adjustment to the P*Q fair value estimate may be necessary.

The guidance in ASC 820-10-35-2B states that "when measuring fair value a reporting entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include, for example, the following:

a. The condition and location of the asset

b. Restrictions, if any, on the sale or use of the asset."

ASC 820-10-35-2C further states, "The effect on the measurement arising from a particular characteristic will differ depending on how that characteristic would be taken into account by market participants."

ASC 820-10-55-52 illustrates how a reporting entity that is legally or contractually restricted from selling an instrument to any willing third party for a specified period (e.g., such a restriction could limit sale to qualifying investors, as may be the case in accordance with Rule 144 or similar rules of the Securities and Exchange Commission) would consider that restriction in a fair value measurement of the instrument. In the illustration, the restriction is a characteristic of the instrument and, therefore, would be transferred to market participants.

> "A reporting entity holds an equity instrument (a financial asset) for which sale is legally or contractually restricted for a specified period. (For example, such a restriction could limit sale to qualifying investors, as may be the case in accordance with Rule 144 or similar rules of the Securities and Exchange Commission [SEC].) The restriction is a characteristic of the instrument and, therefore, would be transferred to market participants. In that case, the fair value of the instrument would be measured on the basis of the quoted price for an otherwise identical unrestricted equity instrument of the same issuer that trades in a public market, adjusted to reflect the effect of the restriction. The adjustment would reflect the amount market participants would demand because of the risk relating to the inability to access a public market for the instrument for the specified period."

The following example illustrates a scenario for which we think entities could benefit from the clarification of the guidance in ASC 820-10-35-2B and 35-2C:

Entity A purchased shares in Entity B, a private company, in December 20X1 and accounts for the investment at fair value under ASC 321, Investments – Equity Securities. In June 20X4, in contemplation of an IPO, an underwriter lockup agreement is executed between the underwriter and Entity A that prohibits Entity A from selling its shares in Entity B through the public markets for 180 days after the IPO. The underwriter agreement is a separate legal document from the related shareholder agreement. The underwriter agreement states that the underwriter, in its sole discretion, may release the securities subject to the lockup agreement in whole or in part at any time. If the underwriter waives the lockup to allow Entity A to sell its shares in Entity B, the underwriter lockup agreement does not state whether the buyer (Entity C) would be subject to the same terms and conditions. Although not contemplated in the contract between the underwriter and Entity A, in practice, the underwriter may require Entity C to enter into a lockup agreement as a precondition of waiving Entity A's lockup. However, that would be a separate legal document between Entity C and the underwriter.

In January 20X5, Entity B completes its IPO, and Entity A's shares are converted to publicly traded common shares, which are now subject to the underwriter lockup. In March 20X5, Entity A is required to provide interim financial statements and is considering how the underwriter lockup might affect the ASC 820 fair value measurement of its investment in Entity B.

We have observed the following interpretations of ASC 820:

View A: Entity A considers the underwriter restriction to be a characteristic of the asset that would transfer to a market participant.

This view may result in Entity A discounting the value of the shares from P*Q to account for the restriction because a typical market participant would require an additional rate of return to compensate for the additional risk related to the inability to sell the security in the public stock market exchange during the lockup period.

Supporters of this view assert that, while the form of the underwriter lockup agreement is a separate legal contract, in substance, the provisions attach to the share. The example in ASC 820-10-55-52 supports this view because it states that the asset is "legally or contractually restricted for a specified period" (emphasis added). Therefore, it is important to evaluate how the lockup provision contractually restricts the sale of the shares subject to the agreement.

Since Entity A does not have the ability to sell its shares in Entity B in the public market stock exchange during the lockup period, the principal market during that period would be a sale of the shares to another investor (typically, a private equity fund that has a strategy of investing in such restricted securities). Thus, the fair value would be measured considering a hypothetical transaction between Entity A and another investor. When Entity A evaluates the hypothetical transaction to sell the share, they determine that the contractual element of the restriction, in substance, attaches to the security. Therefore, when evaluating the assumed transfer of such a position, it is appropriate to consider the restriction to be a characteristic of the asset that would be considered by market participants when pricing the share at the measurement date.

In addition, it is typical that the transfer agent responsible for keeping the records of the securities would keep separate records for restricted and nonrestricted shares, which indicates that the restricted shares are separately identifiable from the nonrestricted shares. Therefore, the restricted shares could not be presented to the company as unrestricted or sold through the public market without the underwriter's approval, even if the restricted shares were given to a third party that was unaware of the underwriter restrictions.

This view is described in Chapter 13 of the AICPA's guide Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies (see Appendix A).

View B: Entity A considers the underwriter restriction to be an entity-specific restriction that would not transfer to a market participant.

This view would result in Entity A concluding the fair value of the common shares is measured using the P*Q value.

Supporters of this view note that because the unit of account is the underlying share and the underwriter agreement does not modify the share, the underwriter restriction is not a characteristic of the share but rather a restriction that is specific to Entity A, the holder. Further, Entity A holds the same underlying shares in Entity B as an entity that is not subject to the underwriter restriction, which evidences that the restriction is only on the entity and doesn't affect the share itself.

Supporters of this view further note that underwriter restrictions do not have the same characteristics of the restrictions under SEC Rule 144A. Based on securities laws, a security subject to Rule 144A can only be sold to qualified institutional buyers, and the restriction on the sale is specific to the security and generally lasts for the life of the security if it is not subsequently registered.

View B proponents also note that the principle applied in View A would potentially have implications for a broader range of restrictions than underwriter lockups. For example, an entity might provide an equity security as collateral for a loan, and the lender might restrict the entity from selling the collateral. If the principle in View A is applied, the hypothetical sale would be a transfer of a security subject to the same restriction. As a result, the fair value of the security would decline when it was provided as collateral for the loan. View B proponents do not believe that this outcome is the intent of the guidance.

These interpretations could result in a different fair value measurement for similar securities with similar facts and circumstances.

In summary, based on the existing guidance, constituents have reached different conclusions regarding how a reporting entity should consider an underwriter lockup agreement in valuing a security. We believe that the FASB should add a narrow-scope project to the EITF's agenda to reduce diversity in practice in this area.

If you have any questions, please contact Paul Beswick or Alison Spivey.

Sincerely

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Appendix A

Excerpt of Chapter 13 of the AICPA's guide, Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies

Underwriter Lock-Ups and SEC Rule 144A

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13.11 When the underlying security is traded in an active market but there is a legal or contractual restriction that is deemed a characteristic of the shares and not of the holder, an adjustment to the P×Q fair value estimate may be necessary. Such a restriction would prevent the fund from accessing the public market and, therefore, the principal market would be a transfer of the interest to another market participant who typically would also be subject to the restriction. FASB ASC 820-10-55-52 provides an example of the effect on a fair value measurement of a restriction on sale, considering the following situation:

> A reporting entity holds an equity instrument (a financial asset) for which sale is legally or contractually restricted for a specified period. (For example, such a restriction could limit sale to qualifying investors, as may be the case in accordance with Rule 144 or similar rules of the Securities and Exchange Commission [SEC].) The restriction is a characteristic of the instrument and, therefore, would be transferred to market participants.

In situations in which the fund holds restricted shares (whether due to a legal or regulatory restriction on the sale of shares, a contractual restriction on the fund through an underwriter agreement, an additional regulatory restriction due to the status of the fund as an affiliate, or some other form of restriction), the fund is prohibited from selling shares through the public markets for a given period of time. When evaluating an assumed transfer of such a position, if any buyer of the position would be subject to the same restrictions, either via direct transfer of the restriction (for legal or regulatory restrictions) or because the counterparty would require that the buyer accept the same restrictions (for contractual restrictions), the task force believes that it would likely be appropriate to consider the restriction to be a characteristic of the asset irrespective of the form of the restriction.

13.12 Fundamentally, the assumptions that a market participant would take into account drive the determination of fair value. A restriction under the SEC's Rule 144A or an underwriter's lock-up that effectively prevents the sale of the securities is considered a characteristic of the asset because the hypothetical transaction could only take place if the restriction or lock-up accompanies the shares when they are sold to a market participant. Thus, the restriction or lock-up would be considered in valuing the asset. Such market participants typically would not pay the full traded price for locked up shares and, therefore, an adjustment typically would be necessary. When there is a restriction on the shares that would be transferred to market participants, FASB ASC 820-10-55-52 indicates the following:

In that case, the fair value of the instrument would be measured on the basis of the quoted price for an otherwise identical unrestricted equity instrument of the same issuer that trades in a public market, adjusted to reflect the effect of the restriction. The adjustment would reflect the amount market participants would demand because of the risk relating to the inability to access a public market for the instrument for the specified period. The adjustment will vary depending on all of the following:

a. The nature and duration of the restriction

b. The extent to which buyers are limited by the restriction (for example, there might be a large number of qualifying investors)

c. Qualitative and quantitative factors specific to both the instrument and the issuer.

13.13 Another adjustment often considered in some valuation analyses (for purposes other than financial reporting) is an adjustment for blockage. In normal conditions, the traded price for a stock reflects an equilibrium between supply and demand. Selling a large block of shares would increase supply, pushing the price down; thus, transactions in large blocks of shares frequently reflect a blockage discount. Because the blockage is a function of the size of the position, however, rather than a characteristic of the asset itself, these adjustments may not be considered in estimating fair value for financial reporting purposes. Specifically, FASB ASC 820-10-35-36B states the following:

Premiums or discounts that reflect size as a characteristic of the reporting entity's holding (specifically, a blockage factor that adjusts the quoted price of an asset or a liability because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity, as described in paragraph 820-10-35-44) ... are not permitted in a fair value measurement.

That is, for actively-traded securities (securities that can be measured within level 1 of the fair value hierarchy), no discount would be allowed even if the block held could not be sold at one time at the traded price. See paragraph 13.19 for a discussion of the application of this guidance to the valuation of interests that would be measured within level 2 or level 3 of the fair value hierarchy.

13.14 The fair value for an asset with a restriction that is a characteristic of the asset would equal the price that would be received in a transaction for the unrestricted asset, adjusted for the effects of the restriction. Consistent with the prohibition of blockage discounts in FASB ASC 820-10-35-36B, the fund would not consider the size of the interest when estimating the discount for the restriction, that is, the discount that would apply for a 30 % interest would be the same as the discount for a 10% interest or even a 1% interest. Instead, the fund would estimate the discount considering the duration of the restriction and the risk (volatility) of the price. See appendix B, "Valuation Reference Guide," paragraphs B.08.01–.08, "Models Used in Calculating Discounts for Lack of Marketability," for a discussion of commonly used methodologies for estimating discounts for lack of marketability.