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SEC Releases Accounting Guidance on "Spring-Loaded" Incentive Awards

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On November 29, 2021, the staff of the Securities and Exchange Commission ("SEC") released interpretive accounting guidance (Staff Accounting Bulletin No. 120) relating to the valuation of "spring-loaded" incentive awards. "Spring-loaded" awards are share-based compensation arrangements (including stock options and other stock-based awards, like restricted stock units) granted shortly before the company announces positive information, such as an earnings release with better-than-expected results or a significant transaction.[1] Although many companies intentionally schedule their equity grants to be made *following* public release of financial and other material information to avoid allegations of "spring-loading" (for example, annual equity grants are often made following the release of earnings), anecdotal cases have shown that some issuers have issued grants immediately before positive market-moving news.

In general, under Accounting Standards Codification Topic 718 (the accounting standard applicable to the valuation of share-based awards), awards are valued for accounting purposes based on their grant date fair value using certain assumptions regarding share price, share price volatility and other factors *as of the grant date*. By timing grants prior to positive market-moving news, the awards would be expected to become more valuable shortly following the grant because of nonpublic information known to the company but not reflected in the share price and expected volatility used for the initial valuation of the award. The SEC guidance makes clear the SEC's position that material nonpublic information in the issuer's possession regarding positive future developments or announcements must be taken into account in determining the accounting value of an award.

This guidance has implications in several areas:

- **Sizing of Grants**. Some issuers calculate grant size (number of awards) based on the accounting value of the award. If positive news is expected shortly following grant, this could indicate a higher fair value per award and a smaller overall grant size.
- **Expensing of Awards for Financial Statement Purposes**. In the case of awards granted shortly prior to positive corporate news, issuers should ensure that the awards are being properly valued for financial statement expensing purposes.
- **Summary Compensation Table Values and Other Compensation Disclosures**. Because financial statement valuation is generally used for disclosure of award values in an issuer's Summary Compensation Table in the annual proxy statement, changes in valuation methodology may impact the values used for compensation disclosure purposes. Similar considerations will be relevant to the Compensation Discussion and Analysis and calculation of the Pay Ratio and other metrics in the proxy statement, or may entail disclosures in Management's Discussion and Analysis or updates to critical accounting estimates.

- **Financial Statement Disclosure on "Spring-Loaded" Awards**. The SEC guidance states that if an issuer is required to make an adjustment to the share price used to estimate the grant date fair value of "spring-loaded" incentive awards, if material, the issuer is also required to disclose how it determined the amount of the adjustment, the characteristics of such awards (including their "spring-loaded" nature) and how they differ from other share-based awards granted by the issuer. Such disclosures would highlight the issuer's use of "spring-loaded" incentive awards and may lead to increased scrutiny from corporate governance watchdogs (such as ISS and Glass Lewis) as well as plaintiffs' counsels.

The SEC guidance demonstrates that equity grant timing is an area of SEC focus and may be a precursor to comment letters or even enforcement activity in this area. As a result, issuers should evaluate and be mindful of financial, operational or other news that may be released shortly following the grant of equity awards and coordinate closely with their corporate governance, finance and accounting teams to consider whether to delay the proposed grants until after the release of the information and, if not, whether the information is material and must be taken into account when awards are valued for accounting purposes. It may also be necessary for issuers to revise existing disclosure controls and procedures to ensure that potential positive material nonpublic information is identified and appropriately communicated in a timely manner to avoid inadvertent creation of "spring-loaded" incentive awards of any type (*e.g.*, stock options or full-value type awards).

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[1] In the mid-2000s, Delaware courts considered whether board members had breached their fiduciary duties by granting "spring-loaded" stock options pursuant to shareholder-approved equity compensation plans that prohibited the grant of options with an exercise price that was less than the fair market value of the underlying stock on the grant date. See, for example, *In Re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563 (Del. Ch. Feb. 6, 2007). As previously noted, the current SEC guidance is not limited to stock options and applies to all share-based compensation arrangements, such as restricted stock units and performance share units.