# Illiquidity Discounts for Mandatory Holding Periods: Facts vs. Fiction

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**Recent statements from the SEC about illiquidity discounts for equity awards with mandatory post vest holding periods have been misconstrued.**

## Introduction

We've received some questions from clients about comments that an SEC official made regarding accounting discounts for employee stock awards that include mandatory post vest holding periods. There is some concern, based on erroneous media reports, that the SEC has changed its position on the discount companies can expense for these awards. However, as discussed below, there has been no change in the SEC's position on this issue, and we continue to believe that it is reasonable and appropriate under Accounting Standards Codification 718 (Topic 718) to consider a discount for illiquidity when estimating the fair value of an award of stock based compensation that will be subject to a mandatory post vest holding period.

## Background

On December 9, 2015, Barry Kanczuker, Associate Chief Accountant, Office of the Chief Accountant, spoke at the 2015 American Institute of Certified Public Accountants (AICPA) National Conference on Current SEC and Public Company Accounting Oversight Board (PCAOB) Developments. Mr. Kanczuker's comments were highly reminiscent of the comments made by Todd Hardiman, Associate Chief Accountant, Division of Corporate Finance, at the 2004 AICPA National Conference on Current SEC and PCAOB Developments. Both Mr. Kanczuker and Mr. Hardiman simply quoted Topic 718 (previously FAS 123R), which provides that, "If shares are traded in an active market, post vesting restrictions may have little, if any, effect on the amount at which the shares being valued would be exchanged." This quote has been repeated many times by SEC officials, resulting in some commentators and self-appointed compensation bloggers continuing to misinterpret it to mean that illiquidity discounts must be insignificant.

The quote is merely a reminder that the range of discounts that can be applied depends on each company's facts and circumstances. It does not dismiss illiquidity discounts. We would point out that instead of "shall have", "will have", or "must have", the accounting standard setters stated the illiquidity discount "may have" little or no impact on the estimated fair value of an award. We whole heartedly agree that for some companies the illiquidity discounts may be relatively modest. On the other hand, if the underlying stock is volatile or the holding period lasts a year or more, the illiquidity discount "may have" a more pronounced impact.

Finally, it's important to note that, in his speech to the AICPA, Kanczuker also said he "would expect that a post vesting restriction may result in a discount relative to the market value of common stock to reflect that the market shares can be freely traded while restricted shares cannot."

## Key Reminders for Expensing

There are some important takeaways that serve as reminders for how compensation and valuation professionals should treat these types of awards:

- The post vest holding period *must* be a feature of the award. For example, the SEC will not allow an illiquidity discount when the only restriction on the award is the result of the recipient being subject to mandatory stock ownership guidelines. Ownership guidelines place restrictions on the employee instead of the award itself. An illiquidity discount *can* be applied when the award agreement includes an absolute prohibition on sale for some period of time.
- The assumptions and methodologies used to develop the illiquidity discount must reflect the perspective of market participants. This takeaway comes from a long line of SEC guidance going back to Hardiman's speech at the 2004 AICPA National Conference on Current SEC and PCAOB Developments, where he said it is "not enough to simply cite the average marketability discount used by your investment banker or to highlight that the amount of the discount used falls within a broad range you noted in an academic study." Hardiman stated the SEC begins evaluating these discounts by trying to understand "the duration of the restrictions and the volatility of the underlying stock. Generally, the longer the duration and the higher the volatility, the higher the discount." As a result of this guidance, it is not acceptable to simply base the illiquidity discount on a rule-of-thumb.

## Next Steps

The next question for compensation professionals and their advisors is how to develop illiquidity discounts in a manner that is consistent with generally accepted accounting principles (GAAP) and will be acceptable to a company's external auditors.

Fortunately, the answer isn't as hard as some might think. There are widely accepted option pricing based models for developing illiquidity discounts that satisfy the guidelines laid out by Hardiman, Kanczuker, and others regarding the duration of the holding period and riskiness (i.e., volatility) of the underlying stock. Option pricing based models, such as Chaffe and Finnerty are widely accepted and are consistent with generally accepted valuation practices for developing estimated discounts for illiquidity. The validity of these models is not that they mimic the underlying economics of the situation (the combination of an illiquid share and a put option does not equal a liquid share). Instead, the validity of the models lays in their ability to accurately reproduce the discounts observed in actual transactions of unregistered shares of publicly traded companies, where the underlying shares may not be sold in the open market for a period of time. In other words, the discounts developed with these models are supported by objective and verifiable market evidence.

## Final Thoughts

For purposes of Topic 718, it is reasonable and appropriate to apply a discount when estimating the fair value of an award of stock based compensation that will be subject to a mandatory post vest holding period. However, as with any estimate that is used for financial accounting and reporting purposes, the

illiquidity discount must be developed using the appropriate model and robust assumptions. If generally accepted valuation practices are used, companies should feel confident that their illiquidity discounts meet the following conditions:

- Discounts match market participant expectations
- Discounts are supported by objective and verifiable market evidence
- Discounts are consistent with SEC and FASB guidance

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