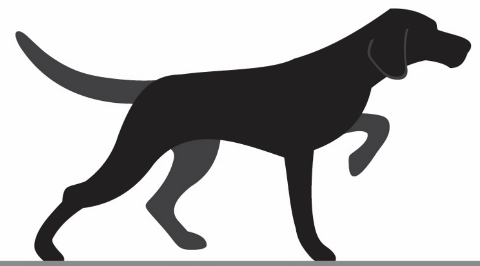
On point.



SEC Comments Relating to Grants of Cheap Stock

The staff of the Securities and Exchange Commission's (the "SEC") Division of Corporation Finance issues comment letters relating to registration statements and periodic report filings. This note examines the issues raised in SEC staff comment letters for IPOs relating to the valuation of equity awards issued to employees at a value that may be considered less than fair value (often referred to as "cheap stock"). Because valuing equity instruments that do not have an active market is quite subjective, often, comments are raised by the SEC staff in connection with the issuer's IPO registration statement. The SEC staff focuses on the price variation between the fair value of the company's common stock at the time of issuance as compared to the anticipated IPO price.

Of the 191 companies that undertook an IPO in 2018, 125, or approximately 65%, received a SEC staff comment letter that contained at least one cheap stock comment. Approximately 47% of these were life sciences and healthcare companies (which accounted for approximately 42% of total IPOs in 2018).[1] From 2017 to 2018, there was a 30% increase in the number of SEC staff comment letters issued with at least one cheap stock comment. In this note, we examine some of the issues raised in the letters so that companies can anticipate and avoid them. This note is not intended to set forth an exhaustive list of all cheap stock comments issued by the SEC staff. Comments can vary widely and depend on a particular company's business and the particular facts and circumstances.

The SEC staff typically comments on valuation discrepancies between the proposed IPO price per share, which would represent the fair value of the stock, compared to the price at which the prior equity awards were granted. The SEC Division of Corporation Finance's Financial Reporting Manual ("Financial Reporting Manual") states that "the staff may issue comments asking companies to explain the reasons for the valuations that appear unusual (e.g., unusually steep increases in the fair value of the underlying shares leading up to the IPO)." The Financial Reporting Manual notes that comment letters are intended to "elicit analysis" so that the staff can confirm the accounting methods used for share-based compensation by the company.

Section 9520 of the Financial Reporting Manual addresses estimates used to determine share-based compensation. Given that there is no public market for the privately held company's securities, determining their fair value can be challenging and inherently subjective. As part of its review, the SEC staff considers whether the company has provided certain accounting estimate disclosures in its IPO registration statement. Specifically, the SEC staff assesses whether the company has discussed "the methods that management used to determine the fair value of the company's shares and the nature of the material assumptions involved" and "the extent to which the estimates are considered highly complex and subjective."

Section 409A of the Internal Revenue Code regulates most nonqualified deferred compensation arrangements. Section 409A provides that a stock option granted with an exercise price that is less than fair market value on its date of grant is a nonqualified deferred compensation arrangement and is subject to adverse tax consequences. To avoid this result, Section 409A provides several safe harbor methods that a company may use to determine fair market value. Most companies opt to use the qualified independent appraiser safe harbor under Section 409A (valuation is determined by a qualified independent appraiser as of a date no more than 12 months before the date of grant). For U.S. issuers subject to Section 409A, having a report issued by a qualified independent appraiser that satisfies the Section 409A requirements is a relatively low cost option to support a company's fair value determination and reduce the likelihood of a cheap stock issue.

The SEC often requests that companies explain the factors contributing to the differences in the deemed fair value of shares of common stock and option grants, as noted in the Financial Reporting Manual. Frequently, the SEC staff asks for information regarding the nature and extent of third-party appraisers' involvement and management's reliance on the work of any independent appraiser. Companies should consider the proximity of the issuance of option grants to the offering, intervening events, transfer restrictions and exercise

[1] https://www.dandodiary.com/2019/03/articles/ipos/a-closer-look-at-2018-ipos/

dates, and the financial condition of the company at the date of the valuation. If the estimated fair value of the stock at grant date is substantially below the IPO price, the company should be able to reconcile the difference between them (for example, explain the events or factors that support the difference in values). The reliability of a valuation specialist's fair value determination may be affected by the timing of the valuation (contemporaneous versus retrospective) and the objectivity of the specialist (unrelated versus related-party).

A company is not required to refer to a third-party expert simply because the company used or relied on the third-party expert's report, valuation or opinion. However, the consent requirement in Item 601 of Regulation S-K is applicable if that report, valuation or opinion of an expert is included or summarized in the registration statement and attributed to the third party.

Examples of SEC Comments

Below is an example of an SEC staff comment and company response relating to a valuation performed by a third-party appraiser.

- "You disclose that your board of directors has historically determined the estimated fair value of your common stock based on the conclusions of contemporaneous valuations performed by an independent valuation specialist. Please revise to clarify the nature and extent of the third-party appraiser's involvement and management's reliance on the work of the independent appraiser." Letter dated October 23, 2015, to Tactile Systems Technology, Inc. (https://www.sec.gov/Archives/edgar/data/1027838/000000000015051195/filename1.pdf)
- The SEC staff subsequently commented as follows: "In response to comment 6, you state that based on feedback received in 2015, you revised your original 2015 fair value determinations but did not adjust any prior periods. Please explain in more detail why you concluded that your original 2015 fair value determinations required revision, the nature of the feedback received, and how the changes impacted your original valuation methodologies. For example, explain if you revised assumptions or added additional valuation methodologies in determining the fair value of your common stock. Tell us why these changes to correct your 2015 valuations should not also be considered for prior period valuations." Letter dated January 21, 2016, to Tactile Systems. (https://www.sec.gov/Archives/edgar/data/1027838/000000000016062110/filename1.pdf)
- Response: "The company historically utilized a market approach valuation method for its 2014 valuations and used a combination of the market approach valuation method and the income approach valuation method for its 2015 valuations. In 2015, the company seriously considered the prospect of pursuing an initial public offering....The lead underwriters prepared a summary valuation of the company to assist the board of directors as it considered whether to pursue the proposed offering. The summary valuation was provided based on the company's performance through the second quarter of 2015 and was primarily a comparable company and comparable transaction review." Response to SEC dated January 25, 2016. (https://www.sec.gov/Archives/edgar/data/1027838/000110465916091220/filename1.htm)

Based on this summary valuation, the company reviewed its fair value determinations for 2015, effectively modifying its valuation approach to include the summary valuation from the lead underwriters as a factor in determining fair value. The company's methodology effectively changed in 2015 from the valuation methodology described previously in the draft registration statement to this three-pronged analysis. Therefore, the company made the decision to use a $200 million fair value for awards granted in 2015.

The company also informed the SEC staff that it considered whether it was appropriate to adjust the fair value for its 2014 equity awards. The company informed the SEC staff that it did not receive a summary valuation in 2014. In addition, 304,000 of the 441,500 stock options granted in 2014 were granted on January 22, 2014, and 62,500 were granted on June 17, 2014. These awards were made over a year prior to the summary valuation received in 2015. Since no summary valuation was undertaken in 2014, 83% of the options granted in 2014 were granted in the first month of the year and the company's performance had materially improved from 2014 to 2015, when the valuation feedback was received (revenue growth of 40% in the first six months of 2015 as compared to 2014), the

company did not make any changes to its 2014 common stock fair value or prior periods. Response to SEC dated January 25, 2016. (https://www.sec.gov/Archives/edgar/data/1027838/000110465916091220/filename1.htm)

Other Examples:

Aptinyx Inc.:

- "Once you have an estimated offering price or range, please provide us with an analysis explaining the reasons for the differences between the recent valuations of your common stock leading up to the initial public offering and the estimated offering price. This information will help facilitate our review of your accounting for equity issuances including stock compensation and beneficial conversion features." Letter dated April 26, 2018, to Aptinyx Inc. (https://www.sec.gov/Archives/edgar/data/1674365/000000000018013023/filename1.pdf)

The company detailed the valuation techniques used in valuing its stock option grants and common stock. In particular, the company noted its use of the Black-Scholes option-pricing model for calculating the estimated fair value of the stock option. The company presented the SEC staff with a table summarizing the equity awards issued during the preceding 12 months. Additionally, the company noted the time of specific value-generating events that occurred between its June 13, 2017, grant date and its December 31, 2017, valuation.[2]

Zoom Video Communications, Inc.:

- "Please provide us with a breakdown of all equity awards granted to date in fiscal 2019 including the fair value of the underlying common stock used to value such awards as determined by your board of directors. To the extent there were any significant fluctuations in the fair values from period-to-period, please describe for us the factors that contributed to these fluctuations, including any intervening events within the Company or changes in your valuation assumptions or methodology." Letter dated February 8, 2019, to Zoom Video Communications, Inc. (https://www.sec.gov/Archives/edgar/data/1585521/000000000019001581/filename1.pdf)

Companies typically respond that they will provide supplemental information to the SEC staff addressing the differences in valuations after they have a preliminary offering price range, as Zoom Video Communications, Inc. ("Zoom") did on February 15, 2019.[3] Often, companies will concurrently amend their registration statements in response to the SEC's comments to their grant of equity awards. For example, on the same day that Zoom responded to the SEC's comments noted above, it submitted an amended draft registration statement in which it specifically addressed the SEC's comments. (*Draft Registration Statement, dated February 15, 2019*. https://www.sec.gov/Archives/edgar/data/1585521/000095012319002401/filename1.htm)

In the amended registration statement, Zoom specifically noted the fair value of its stock-based compensation awards was estimated on the grant date using the Black-Scholes option-pricing model. Zoom listed the assumptions and estimates it used when estimating the fair value of its stock-based compensation. Zoom noted that the risk-free interest rate used for the expected term of the options was based on the U.S. Treasury yield curve at the time of the grant. Zoom also described the expected term and the specific method used to calculate the expected term of the options. Zoom used a simplified method that calculates the expected term as the average of the time to vesting and the contractual life of the options.

Zoom also described, in a separate section, its common stock valuations. Zoom noted that it uses a market approach and compares the company to other public companies in similar lines of business. Specifically, Zoom stated the following:

- "Our assessments of the fair value of common stock for grant dates between the dates of the valuations were based in part on the current available financial and operational information and the common stock value provided in the most recent valuation

[2] Response to SEC dated May 23, 2018. (https://www.sec.gov/Archives/edgar/data/1674365/000110465918035487/filename1.htm)
[3] Response to SEC dated February 15, 2019. (https://www.sec.gov/Archives/edgar/data/1585521/000095012319002402/filename1.htm)

> as compared to the timing of each grant. For financial reporting purposes, we considered the amount of time between the valuation date and the grant date to determine whether to use the latest common stock valuation. This determination included an evaluation of whether the subsequent valuation indicated that any significant change in valuation had occurred between the previous valuation and the grant date." *Draft Registration Statement, dated February 15, 2019, page 72.* (https://www.sec.gov/Archives/edgar/data/1585521/000095012319002401/filename1.htm)

Letter dated February 28, 2019, to Zoom Video Communications, Inc.
(https://www.sec.gov/Archives/edgar/data/1585521/000000000019003537/filename1.pdf)

Anticipating SEC Comments

Companies can take several steps to mitigate the risk of receiving a cheap stock comment from the SEC staff. As noted above, companies may rely on a Section 409A valuation safe harbor and maintain a report issued by a qualified independent appraiser that was prepared within 12 months of the fair value determination. Companies may consider hiring a third-party valuation professional in the months leading up to the IPO to support their disclosure. In their disclosure, companies should highlight the independence of the valuation consultant and the techniques used by the valuation professional in determining the fair value of their common stock.

Companies should contemporaneously (with option grants) value their common stock at regular intervals. When doing so, they should provide the assumptions and estimates underlying their valuations. These can be included in board minutes or in the materials presented to board or committee members. If there are any changes in those assumptions and estimates between grant dates, then companies should address those changes. Companies should also note the factors they considered when making these valuations, such as their financial performance, significant milestones and business and market conditions. The current and ongoing COVID-19 pandemic adds an additional wrinkle to the market conditions analysis.

For companies that have completed a private financing, usually they will have sold convertible preferred stock to investors. However, the price at which the convertible preferred stock was sold presumably reflects its fair market value since it was negotiated with third parties on an arm's-length basis. From this price, management can extrapolate a fair value for the company's common stock. Now, more private companies allow their option holders or early investors to sell their securities in private secondary markets. The prices at which shares are traded in private secondary market transactions also may provide a useful indication of fair market value.

Companies are required to disclose the methodologies used to determine the fair value of their stock-based awards. As such, companies should specifically disclose the valuation model and technique used and the different components that went into determining the value. These components might include but are not limited to, the expected term of the options, the expected volatility of the stock based on peer public companies, and the interest rate used in determining the fair value. If there are any fluctuations in the fair value of its awards from period to period, the company should provide a detailed explanation of the factors that may have led to these fluctuations If the company used different methods to value different types of awards, these should be disclosed too.

Companies should also discuss their valuation approach in the Management's Discussion and Analysis section of their IPO registration statement, including changes in the fair value of the common stock between the grant date and the IPO. Because the SEC staff typically issues cheap stock comments later in the registration process (generally once a preliminary price range is identified), companies may want to provide sufficient detail regarding their valuation approaches to anticipate and head off any potential comments.

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