Venture Secondary 101

A how-to guide for companies & investors

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> *"Venture secondaries can be an invaluable retention tool by providing partial liquidity for founders and employees"*
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History and Current Environment

Ten years ago, there were few, if any direct purchases of shares or securities in venture capital (VC) – backed technology companies. These secondary sales (as opposed to the traditional VC or "primary" investments directly into companies) by founders or employees were rarely permitted by VC investors or the company's board of directors as investors in the company wanted the founders and executives to share the same long-term commitment. In short, if the investors had to wait until a company exit for liquidity then the founders and executives would likewise need to wait.

Investors believed that allowing employees to sell shares early for partial liquidity created a misalignment of interests between the investors and the employees. The company and the board also sought to avoid potential negative external perceptions of the company arising out of executives and other insiders disposing of their shares early. Typically, the VC investors and board would only allow a "de minimus" number of shares to be sold or transferred by founders or executives, other than for purely estate planning purposes. These restrictions forced employees to consider leaving the company to address their own personal liquidity considerations that arose from "life events" such as divorce, home purchases or college tuition payments. For companies, this became an unintended but clear employee retention issue.

The restrictions on selling shares also adversely affected recruiting of top talent. Prospective employees choosing between privately-held and publicly-traded companies have always had to consider liquidity of their shares: illiquid shares in a private company with upside potential, or liquid shares of a publicly traded company with limited upside. Transfer restrictions further tilted the scales in favor of the publicly-traded company alternative, causing private companies to lose talent to larger publicly-traded companies.

Today, secondary transactions have become more and more frequent, and are expected to remain prevalent. The market for direct purchases of shares in private, venture capital (VC)-backed technology companies has been growing over the last 10 years. There are several macro reasons for the increased interest and volume of secondary transactions. The median time to exit at IPO in 2016 has increased to nearly 7 years after first VC funding compared to 4.8 years in 2006 (NVCA/PitchBook, March 2017). The slowdown in the IPO Market has also contributed to this increase as there were only half as many (39) VC-backed IPOs in 2016 compared to 77 in 2015 (NVCA/Pitchbook, March 2017). Many high-profile, later-stage companies have been able to continue raising additional capital to withstand the extended time to exit. It is estimated that the private market for tradable shares has increased by more than 3 times from $11B in 2011 to $35B in 2016 and is expected to grow to $37B in 2017 (Scenic Advisement, Dec 2016). For all founder and employee shareholders

in these startups, equity has value only if there is the potential for liquidity.

With this increased demand for secondary transactions comes an emerging need for the development of a structured process by which companies can provide employees with partial liquidity to alleviate external pressures from life events and can motivate staff. The demands for liquidity driven by life events such as divorce, home purchases, and school tuition cannot be planned or predicted and are independent of the economic cycles, and therefore do not line up neatly with startup timelines to exit and liquidity. In addition, for CEOs and boards of directors of startups, their success in recruiting and maintaining talent will be partially determined by their ability to provide partial controlled liquidity.

Issues and Challenges

The potential slowdown in venture funding for private companies in all stages of development will lead to uncertainty for all stakeholders – founders, employees, and investors. The notion of providing any partial liquidity for any of the life events reasons described above may be impractical for some potential buyers such as the existing investors or VCs. These traditional primary investors cannot always meet the needs or demands for internal liquidity because their capital may be outside of their deployment cycles or that their capital is already earmarked as “dry powder” for future rounds of funding. In addition, some primary investors may be reluctant to internally price shares in an existing investment.

There remains some hesitation among startup executives to pursue secondary transactions in more mature, pre-IPO companies as a result of the challenges and difficulties that Facebook and Twitter encountered in the run-up to their IPOs. In 2012, the pre-IPO rounds of funding for these two companies highlighted strong demand for secondary transactions and the importance of a controlled transaction environment. The resulting large swings in pricing in Facebook shares prior to its IPO illustrated the negative impact of an uncontrolled and unregulated secondary market on the public offering process.

Another important consideration is the impact of any secondary transaction on the company’s 409A valuation which is used to determine the fair market value (FMV) of a company’s common stock. In assessing the value of the company’s common stock, the 409A valuation firms examine (among other things) all transactions involving the purchase and sale of the company’s equity securities and determine their impact on the common stock valuation. Generally, these firms do not significantly weight one-off transactions involving non-insider sellers and/or buyers, as they assume that such transactions are undertaken without the parties’ knowledge of all material nonpublic information relevant to the investment decision. Further, valuation firms have generally not viewed one-off purchases solely from executive officers and key employees of the company to significantly impact the valuation of the common stock. The reasons here are a bit more complicated and based on the view that the incentives on both sides for completing these transactions result in the consideration of factors beyond purchase price.

- First, as retention of officers and employees is often of tantamount importance to the success of the company, investors are often willing to pay more to these parties than they otherwise might for the same class of shares from stockholders whose services are not as critical to the company. The valuation firms often will tacitly attribute a significant portion of the purchase price to the incentive to keep this class of sellers happy with the outcome of the secondary sale transaction

- Second, executives and key employees often agree to sell their shares in order to help bridge certain gaps in equity financing rounds. At higher valuations, it becomes more difficult for new investors to satisfy their minimum new investment ownership requirements without overcapitalizing the company with too much cash or lowering the otherwise agreed-upon company valuation. Enabling purchasers to obtain additional ownership through secondary purchases from existing stockholders can help overcome this problem for new investors. When these purchasers are part of a larger financing transaction for reasons such as these, valuation firms will often determine that the purchase price of common stock from existing stockholders doesn't necessarily impute a true value to the common shares

Other factors limiting the 409A valuation impact of these transactions are that the relatively smaller transaction size compared to a primary round combined with a single counterparty are often viewed to not be representative of a real market for the shares upon which a valuation can be determined, and that the strict transfer restrictions generally in place at these companies significantly reduce the likelihood that any purchase price can be consistently obtained by stockholders in a manner that would cause one to determine that the purchase price reflects fair market value.[1]

It should be noted, however, that as any particular company undergoes more and more of these secondary stock sales, many of the justifications for their not having a significant impact on the independently-determined valuation of the common stock begin to erode and the transactions are given more and more weight.

Sellers must manage the tax impact of their liquidation event. Depending on the facts and planning, sellers may pay tax at a rate greater than 50% or as low as potentially 0%. Generally, the amount realized on an exit is reduced by the adjusted basis (i.e. cost basis) in the shares sold. In pre-IPO companies, the adjusted basis can be insignificant in relation to the amount realized – resulting in a large gain. In addition, tax results are further complicated by the exercise of stock options depending on the type of such option. Restricted stock grants, non-qualified stock options, incentive stock options, etc., can be taxed differently and can yield vastly different after-tax cash results.

As an example, exercising certain types of options may lead to ordinary income (taxed up to a 39.6% rate for federal purposes, plus any state income tax). Common planning techniques include certain elections that allow for immediate taxation on issuance of stock options in exchange for all future growth to be taxed at capital gains rates (currently 23.8% in most cases).

Further, certain types of shares may qualify for complete exemption from federal income tax, assuming the founder held the shares of a corporation that was in a qualifying trade or business, for 5 years or more, the corporation had net assets of $50M or less when the shares were issued, and met other technical qualifications.

Wealth transfer planning (for both family and charitable purposes) should also be considered early in the life cycle of the potential liquidity event. If addressed too late, the effectiveness of the wealth transfer to family or charity could be hampered. Ultimately, timing of the sale may affect the net after tax cash, and professional help may be required.

The number and types of shareholders in a company are critical dimensions to the corporate structure of a company. This

[1] Years ago, in most VC-backed companies, rights of first refusal were the only transfer restrictions in place on most common shares. The increasing frequency of secondary sale transactions then caused companies to lose control of their capitalization tables, as shares could be transferred freely to third parties assuming that companies didn't have the funding or desire to exercise these rights at significant purchase prices. Many companies have responded to this trend by implementing bylaw and contractual terms which require the company's approval of any transfer of shares whether or not a right of first refusal is in place (with very limited exceptions for transfers for estate planning purposes).

capitalization table management becomes even more important when there are secondary transactions contemplated by the company. The management team and board of the company both desire a small and limited number of investors to ease the communications and investor relations burden for the management team. Adding new investors to a startup who are not a part of the VC ecosystem introduces both complexity and business risk. New potential investors who do not share the same long term view as the existing VC investors bring different expectations on company development and exit as well as the potential for trading of the shares on a frequent or short-term basis. This in turn can drive the 409A valuation higher (thereby compressing the upside for new employees and making it more difficult to attract quality talent to the company). In addition, as stockholders of the company, any third-party purchaser of these shares will have certain rights under applicable law to inspect and review certain confidential information regarding the company (such as stockholder ledgers, financial statements, board minutes and other corporate records), subject to certain exceptions and limitations. Accordingly, if a company is considering secondary transactions for its founders, executives, or employees, it is strongly recommended that the new investors or buyers of the common stock be investors who are part of the VC ecosystem or "insiders."

A secondary transaction for shares of a VC-backed startup affects the key stakeholders in a company: the founders and/or employees, the VC investors and the company itself. The alignment of interests of these key stakeholders is essential for the success of any secondary transaction within the company. For the founders and employees, there is access to partial liquidity of their shares in working with a buyer that is efficient, experienced, and professional. For the VC investors and the board, secondary transactions, if done properly, minimize distraction from the operations of the business and improve executive retention. The company also improves its standing with employees by providing an employee benefit through a structured liquidity program that greatly enhances employee retention. The company benefits from bringing aboard a new investor through this secondary transaction who can contribute immediate value since the new investor is part of the VC ecosystem and ideally has decades of experience in bringing value to management teams as a VC. The company gains a controlled and managed investor base. To realize these benefits, all of the key stakeholders, including the new investor, must work to maintain this alignment of interests.

The actual process by which a secondary transaction takes place must also be handled among the key stakeholders in a coordinated manner. The management team and/or the board help determine the right direct secondary investor. The most important characteristic of direct secondary investor is that they are considered a trusted future partner to the company. Startups and VC investors prefer to avoid risk in terms of the capitalization table, the investor base, the 409A valuation and employee retention, or the business operations itself that could result from closing a secondary transaction with investors who are considered not trustworthy. This trustworthiness is developed and cultivated by working closely among the VC investors in the VC ecosystem for a long period of time. These investors should be previously known or diligenced by the company and investors and should be known by the VCs as long-term investors.

While the transaction may be driven by the management team and board, the working level process is led by the company's CFO or occasionally the general counsel (GC). The key functions and emphasis of the CFO or GC are to manage proprietary company information, to help to determine the seller eligibility requirements (who can sell, how many shares, etc.), and to work with the direct secondary investors (buyers) and the executives or employees (sellers) to enable a smooth and efficient transaction with minimal disruption to the company. Ultimately, management of the process is key to a successful secondary transaction. In addition to identifying the best investors with deep experience, the company has many considerations to address including the transaction's potential impact on the 409A valuation (as discussed above), controlling access/distribution of proprietary information, keeping the board updated and involved, ensuring that the

new investors are aligned with the company's long term vision and goals, and that the transaction does not result in the creation of a "secondary trading market" for the company's equity created by the new investors.

The case of a secondary trading market poses a particularly challenging situation for the company. The potential fluctuation of the stock prices in this type of private market brings the significant risk of demotivating employees. For example, T. Rowe Price marked down several later stage investments in companies such as Cloudera and Dropbox based on factors including the prices at which shares of these companies were traded in these markets. Additionally, a private market comprised of many 3rd party transactions of a company's shares can cause significant increases to the 409A valuation, limiting a company's ability to attract new employees. Further, secondary markets for private company shares cause significant potential concerns under Federal and state securities laws which generally require buyers and sellers to be in possession of generally the same material information regarding the company whose securities are being traded. Lastly, as suggested above, a wider stockholder base can result in more potentially confidential company information coming into the hands of a larger group of people without relationships with the company, which can be susceptible to leaks and even public disclosure by rogue stockholders. These considerations further reinforce the importance of companies taking control of these transactions by dealing with professional and trusted secondary investors to "partner" with the company to address the concerns described above.

What other possible options are available to employees to accomplish partial liquidity effectively and efficiently? In many ways, the secondary market in the recent past has resembled the "wild west" in terms of regulation and transparency. Derivative transactions designed to enable stockholders to separate the economics of stock ownership from legal ownership of shares developed as well as third party-operated quasi-marketplaces from private company stock - each having legal and practical challenges. Derivative transactions in this context are attempts to transfer the economic value of shares while the seller retains legal ownership of the shares, all in an effort to avoid (at least technically) noncompliance with transfer restrictions (including rights of first refusal) limiting the ability to transfer title to shares without company consent. In 2015 the SEC began investigating groups and individuals acting as brokers who were offering these and other derivative transactions to employees of private companies in potential in violation of the Dodd-Frank Act of 2010. The use of these derivatives was also typically not permitted by companies (though increasingly difficult for companies to monitor and regulate).

In addition, third-party quasi-marketplaces for secondary transactions have also been difficult for a number of reasons. These marketplaces have historically served the function of matching buyers and sellers with similar price points, but haven't eliminated the need for the parties to negotiate stock purchase agreements. Transactions facilitated by these marketplaces - where typically the company is not involved and the seller, as a current or former employee of the company, often has company material nonpublic information in his or her possession - can result in potential exposure to the sellers based on the seller's failure to disclose material information about the company to the buyer. The SEC has publicly noted its concerns over this issue and unless companies agree to make key confidential information available to the buyers in these marketplaces (which is unlikely), transactions in these marketplaces will continue to be risky for sellers in particular.

Regulation of exchanges, marketplaces, and broker dealers may be difficult to predict in the current political environment. On the whole, many experts believe that regulation will not be reduced in the short to medium term. The greatest challenge for regulatory agencies may be the pace of technological innovation in investments and financial services as seen in marketplace lending and crowd funding services. This would imply that regulatory pressure dealing with these and other subsectors of the finance world is coming although relatively slowly compared to the pace of technology innovation.

Broker-dealers have been specifically targeted by the regulatory bodies, and will likely continue to see significant costs to doing business from a controls and procedures perspective. Pending changes from 2016 to 2017 include the Department of Labor fiduciary rule for retirement accounts (which could continue to increase business costs for broker dealers), decreases in commissions from a slowdown in the sale of high-priced non-traded investment trusts due to an industry account-statement rule, and a growing focus by individual states on enacting legislation that would make it mandatory for financial services professionals to report elder abuse. Overall, the cost to entry for broker-dealers is becoming more and more cumbersome. The main driver of those costs is compliance. These legal restrictions and other challenges have led to buyers and sellers to work together and in tandem with companies to ensure that the transactions pass scrutiny and are executed properly. Most importantly, companies should work with trusted groups who are known in the VC community and who understand the regulatory environment.

Selection by Company of a Direct Secondary Partner

How does the company or seller actually identify and choose the best direct secondary buyer? Holistically, one can view venture secondary investments as the new emerging plank of the venture capitalization platform, joining traditional primary VC equity, bank debt, and venture debt. A new class of long-term investors has emerged to fill the void, representing the professionalization of the venture direct secondary market.

These long-term investors work directly with companies directly, based on established relationships in the VC community. They tend to be trusted by the company's investors, management, board and employees. Their long-term alignment is with, and their commitment to, the company and maximizing its ultimate enterprise valuation. In addition, these investors have the ongoing capability to be regular sources of capital to meet the liquidity needs of founders and employees over time as trusted partners.

They manage the direct secondary process as opposed to leaving it to an "ad hoc," unmanaged and uncontrolled process, which can lead to the unintended adverse consequences described above. The most effective direct secondary partners in this capitalization platform are those firms such as FEP that are comprised of VCs who understand the concerns faced by VC-backed companies and who know, based on decades of experience in the industry, how to partner with them to provide not only a partial liquidity solution for employees, but also a seamless solution that contributes to the company's long-term goals and ultimate success.

The development of the venture secondary market is analogous to the evolution of the venture debt market over the past 10 years. The venture debt market saw a transition from an unorganized and nonstandard form of financing to a new and institutionalized source of capital that has become much more organized and efficient. Venture debt providers are now considered institutionalized, with both commercial banks and specialty venture debt providers providing this type of financing. Much like the VC investors, they position themselves as value-added partners with interests aligned with the existing investors and management, with the same long-term view and emphasis on trusted relationships.

Historically, the alternative direct secondary investors or buyers such as traders and brokers who have been outside the VC ecosystem have loyalty only to the "trade" or commission – not the company, the employees, or the new investors. To these alternative buyers, it is simply a transaction to be completed and not a long-term investment. This short-term

perspective leads to increased number of trades, misaligned interests among the stakeholders in the company, and ultimately mistrust between the traders and brokers and the company.

What are the important characteristics of the right direct secondary investor?

- Possess deep VC experience in both primary and secondary investments
- Direct secondary buyer should be a Silicon Valley "insider," with strong track records with other VC-backed companies
- Bring value to company
- Trusted partner and long-term view of relationship
- Extensive relationships in investment and entrepreneurial communities
- Ability to make investment decisions quickly

The ideal venture secondary investor works alongside the company in much the same way as existing VCs. It should be willing and able to use its resources to assist companies with recruiting, business development and sales, to complete additional investments if needed, and to react quickly to financing conditions. It must be able to complete a managed, predictable, and smooth process with minimal management distraction for the company's core business and operations. Finally, the ideal investor must have the clear and consistent track record and history of closing transactions. Neither the company or the buyer want to invest the time and energy in a transaction that fails to close.

Selecting the right secondary partner is an opportunity for the company to enhance its business over the long-term in a non-dilutive manner. Direct secondary transactions are not simply serving a need for employee partial liquidity. They also provide an opportunity for the company to gain a competitive advantage by bringing aboard value-added partners.

The Secondary Process

The direct venture secondary investor (buyer) will work closely with management and the board to manage a smooth process for the company, buyer, and seller. As part of the planning and execution of the direct venture secondary transaction the seller should carefully consider different structures that are suitable for all stakeholders and are the most likely to have a minimal impact on the company's 409A valuation. Ease of implementation and simplicity of structure will also be key to a successful transaction.

Direct Purchase Agreement

The simplest approach to early liquidity is for a buyer and seller (or small group of sellers) to directly enter into a stock purchase agreement for the purchase and sale of a fixed number of shares at a fixed price (often with the company also becoming a party to the agreement) with the purchase occurring either all at once over a defined period of time. This can be done quickly and efficiently and can be closed immediately upon agreement to the pricing and other key terms of the transaction.

Series FF Shares

If the selling stockholder holds Series FF shares (sometimes called Class F shares), a similar direct purchase agreement for these shares can be used to purchase these shares. Series FF shares are designed to facilitate early liquidity for founders by enabling them to maximize the purchase price for their shares, while also reducing the risk of the sale causing a meaningful impact on the 409A valuation. The Series FF shares are created and issued at the company's inception at

the same time as the common stock founders shares. The Series FF shares are the same as regular common shares, except that, upon a sale of the shares (with certain exceptions), the Series FF shares automatically convert into shares of the company's most recently issued series of preferred stock. This enables the purchaser to receive the same type of shares most recently purchased by other investors directly from the company, which makes it easier to justify paying the preferred stock price. In addition, the 409A valuation of the common stock is less likely to be affected by a sale of Series FF shares given that they are different classes of equity.

Structured Liquidity Programs

For transactions with larger numbers of selling shareholders, buyers and companies can establish a structured liquidity program (SLP) for employees to sell a percentage of their vested holdings (stock and/or options) to a single buyer or group of buyers to address employee retention issues for companies in competitive labor markets. Ideally, the single buyer will be a quality direct venture secondary investor and trusted counterparty. SLPs are typically effected through a tender offer process, where the buyer(s) offer to purchase up to a fixed maximum number of shares from the employees at a fixed price and subject to a fixed set of rules (cutbacks, overallotments, and others) and other conditions. These offers are generally negotiated with companies up front (rather than with individual employees/sellers) and must be kept open for approximately a month under the relevant securities laws. This structure is generally required when more than a handful of sellers are involved and the terms of the transactions are not individually negotiated with each seller. While a bit more involved than direct stock purchase agreements, with the right legal counsel involved, the process for these SLPs is relatively straightforward with only a modest expense for setup costs for the first tender offer. The subsequent tender offer processes for SLPs on generally similar terms as the prior would generally require minimal expense.

[2] These transactions can also be used to provide liquidity to non-employee stockholders, such as early preferred shareholders, and current and former consultants, advisors and directors.

THE RIGHT PARTNER OF CHOICE

FEP Approach and Experience

FEP is at the forefront of the emergence of this new plank of the venture capitalization platform. FEP is a comprised of VC investors who understand the concerns of all of the key stakeholders in the secondary process and know how to work with the company as a partner to provide an effective solution that is seamless and contributes to the long-term success of the company. In comparison to traders and brokers who have initially inhabited this direct secondary arena, FEP is considered a trusted partner to the company.

As a new breed of investor, FEP exemplifies the right type of venture secondary investor: deep experience spanning over 15 years in venture and venture secondary investments, a keen understanding of the issues and how to avoid the landmines in the secondary process, and strong relationships within the VC community, leading to trust and familiarity. Furthermore, the ability to add value to company in a non-dilutive manner and with a long-term investment outlook is especially attractive to management teams and boards of directors.

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