QuickLaunch University Webinar Series Transcript
The New Bull Market? Private Secondary Shares

May 16, 2018

Presented by WilmerHale Partners Dave Gammell and Daniel Zimmermann, and Nasdaq Private Market Legal Channel Director Kevin Gsell.

Dave: Hello, everyone, and welcome to today's QuickLaunch University Webinar. My name is Dave Gammell and I'm a partner at WilmerHale and the co-chair of the firm's Emerging Company and Venture Capital Practice in Boston. I'm joined by my colleague Daniel Zimmermann who's also a partner in the firm's Corporate Practice based in Palo Alto.

Throughout the year, we've explored many different legal issues faced by entrepreneurs and early stage companies as they begin to build their businesses. If you're interested in listening to our previous session, links to the on-demand online recordings are posted on our website at wilmerhalelaunch.com.

Today we're joined by Kevin Gsell, Legal Channel Director with NASDAQ Private Market to discuss private secondary shares. Prior to joining NASDAQ Private Market in 2015, Kevin held positions with Second Market CSE and MetLive where he focused on sales, account management and financial services. Welcome, Kevin.

Kevin: Appreciate it, Dave. Pleasure to be here.

Dave: Today, we're going to talk about secondary transactions. In order to do that, I think it's important to set the stage with an understanding of what secondary transactions are and what has led to the rapid and dramatic rise in secondary transactions. From a macro environmental level, there are a number of factors that really contribute to the popularity and as you'll see from the data, the rapid increase in the secondary market. One of those factors is time to liquidity. Companies are growing for longer periods of time, there are longer layers before they have any sort of liquidity event. A lot of that is driven by a fairly dramatic slowdown in IPOs compared to historic norms and that's been a macro trend over a number of years.

Fortunately, at this point, the IPO market is showing signs of bubbling a little bit, which is nice for us corporate attorneys, but it's still much slower and much harder and a less favored outcome than it used to be, especially when I started my legal career back in the late 90s and the early 2000s. M&A also is fairly dramatically down over the last year and a half. Again, there's a little increase in that market in this last quarter, but all those things have led to companies being longer lived. There's also an incredible surge in the amount of private capital out there and the amount of private capital that is looking to be put to work. So that's driving longer life expectancies—companies that used to have to raise capital in the public markets to continue to grow [now] have new and bigger pools of capital that are private, and they can access that. It also has led to increasing demand for the shares of good companies, and that's leading to a growth in the secondary market. Another enabling feature that has collided with this demand for secondary shares and the requirements for secondary market has been the role of companies like Kevin's and NASDAQ's Private Market, which used to be Second Market, in really professionalizing the process. There are now established players, established processes and the market, as I mentioned earlier, is large. With that, Kevin, maybe you can walk through some of the data that you have.

Kevin: Absolutely. Thanks, Dave. It's been an interesting landscape that we've seen over the last five years where this market has grown and evolved exponentially. Just to give some context, at Second Market, this market began with the old Facebook days, you know, we were hoping to facilitate one-off rates for ex-employees and, ultimately, private companies came to us and said, "we don't really like what's going on here in the private market where we can't control who can buy and sell, "It was what we call the "Wild West days." We saw this market as being something where if we're going to be in and supported, we have to support what the companies want, right?

We decided to use the approach of "we're going to position ourselves where if companies want to provide liquidity to their employees, we're going to support them in a structured manner where they can basically determine who's going to participate at what price and so forth." And, back in 2012, 2013 when we started doing the first few broad based structured tenders, I think we thought that this was going to be a decent market. I'd be lying if I said we projected it to be what it is today. It's been pretty impressive. The idea of offering liquidity now has become so much more mainstream. This was a Silicon Valley-centric idea, really, for so long where you could think of a lot of the big unicorns that began to do this. But that's really evolved over the last two years, especially where geographically we're seeing more and more companies begin to understand how they can offer liquidity to their employees and do it at different stages now. The unicorns of the world are running this program and some of those next level private companies as well.

From the slides here, you can see a little bit of the evolution. In 2016, we ran 32 programs. Last year, we ran 51 programs. And this year, we're projected, in the first half of 2018, to facilitate about 35 programs. So right there tells you that this market is still growing. And we expect it to continue that way. It's been pretty impressive. We were just having a conversation with a CFO of a large company two weeks ago and he said about a third of folks that are interviewing in his company now, in the interview process, will ask the question "do you provide liquidity to your employees?" That's something that was probably never asked a few years ago. It speaks again to this trend becoming more and more mainstream.

Dave: Absolutely. With companies, surviving for longer and company valuations growing dramatically, it becomes a real problem for employees that that promised land of the equity incentive is something that they may not actually attain unless companies have programs like this and it can be a real retention issue.

Kevin: Absolutely. And with that, as I was saying, generally the rule of thumb we used for engaging with companies was that the company had probably a billion-dollar valuation and probably raised north of half a billion dollars. That's changed now. We're now talking to companies who have raised their B or C rounds and maybe have a valuation that's around $300 or 400 million but they're just starting to want to have that conversation of "You know, is this something we should look into? Is this something we should consider?" And we're lucky we were able to provide some good insights as far as the dos and don'ts and when to consider structuring an event like this.

Dave: If I'm looking into your slide correctly, down in the company programs, it looks like actually a majority of the transactions, maybe not a majority of the dollars, but a majority of the transactions that you guys did were actually for companies under a billion-dollar valuation.

Kevin: Absolutely. You're exactly right. And that's just it. We run a lot of programs for companies where we're just doing it for maybe 50 or so employees. But there's a great instance just a few months ago where, out your way Dave, we ran one for a private company in Waltham, Massachusetts who had just been private for about 16 years. And really, the driving factor for them was to do a company buyback where they wanted a buyback of about $5 million and clean up their cap table and get some of their old ex-employees off the cap table and reward some of those long-standing employees.

Dave: Makes a lot of sense. One thing we should probably say, Kevin, and I think you'd agree with this, is that why you guys are definitely a leader in this marketplace, is your data is likely skewed towards bigger programs and bigger companies because I know a number of our clients will run a program that's either a tender offer or a buyback and we'll talk about what each of those mean as we travel further through the presentation. But they do it on a private basis because it's either a smaller transaction or they think that they can manage it because there's a fewer number of employees or participants or it may even be one off. While your data is certainly useful, it's probably not representative of the entire market. Right, Kevin?

Kevin: Agreed, it's definitely skewed that way. And to further that point, some of those larger companies now will run one program a year. This is just a part of their compensation package now. It's something that for them is a recurring event.

Dave: One other thing, incorporating our audience without actually letting them speak, somebody wrote in a question. It's notable that life science, biotech, medtech is really not part of the mix here. You know, one of the things that I'd say about that is the fundraising trajectory of life sciences is just different than tech generally. One of the drivers, if you'll remember and, Kevin, I'd love your impression on it too, but one of the drivers of this is companies that don't otherwise have liquidity and are not going public. In the life sciences space, capital raising is still done and done very early on often by public offering and the acquisition rate of life sciences company is just very different than tech. I think those macro trends we pointed to at the beginning are not nearly as applicable to life sciences companies. In the life sciences our firm has had an incredible run in the IPO market over the last several years. I think that's probably one reason. I don't know, Kevin, if you have thoughts on that as well.

Kevin: I think you're exactly right on that. You represent some awesome, awesome biotech companies. And so they're more inclined to go public much sooner than a traditional tech company. And to further that point, when companies are raising money, they'll allocate a portion of that money, after potential like a primary closing to doing a buyback or something. But a lot of times, the funds being raised by a life science biotech company, some of that is also being used for R&D as well and it's not necessarily going to be used for employee liquidity. We've spoken with a few companies. We've actually run, I think, one or two with a few of them, smaller transactions but it's traditionally not a sector we see much.

Dave: Great. Thanks Kevin. Daniel, do you want to talk about who's dancing at this party so we can set the stage? We've given a lot of data and it might be helpful to understand better who the participants are.

Daniel: Absolutely. Thank you for everyone participating here. Who's dancing at this party? Ultimately, we've got sellers and we've got buyers, right? There's a very traditional field process in the sense of that we always need a seller or we need a buyer, able and willing. And essentially what we have seen over the years is that we've had, of course, a lot of founders and early employees sell because, of course, they have been in this, "investment or equity position" for the longest and ultimately are probably motivated to get a little bit of money on this to the side and just diversify their holdings broadly speaking. Because a lot of them as we know really, the only asset they have if you're a full-blooded founder, you're essentially holding the shares. That's probably all you have.

You don't even pay yourself very much, probably below market, and it's definitely something that maybe your spouse or your most significant other is pushing for to get just a little bit of liquidity. Because you've got all this press, this great press, over the years but you really have nothing to show for it, so they're very motivated and they're certainly dancing at this party. And others are potentially investors, and we just talked about how long some of these investors are actually in these investments at this point. The regular fund life is 10, 12 years, as we know. And they're limited partners, there's a pecking order, the limited partners for those investors are potentially knocking on their doors, "Hey, when are we going to finally see something here because we've been in this investment for a long time." And, of course, sometimes there's just a shift in focus on investments, etc.

But broadly speaking, we do see investors looking for some liquidity. And of course, we are sometimes seeing this as we've talked about earlier, really as broadly speaking, coming from the company as a retention facility, it is something that the company is really pushing for because if there's a new capital raise in particular, there's potential for essentially doing redemption at the same time, buyback at the same time, because not all of the cash is actually needed for operating capital if the company is doing well. A lot of these companies are doing very well. They're in good cash positions. They, of course, also have other sources of funding such as bank facilities, etc.

It is possible to use some of the capital raised, the money that's raised, in that situation. The buyers are, again, certainly also current investors because a lot of the current investors continue to be interested and think very highly of a particular company and want to actually get a deeper position potentially—especially the ones who came in at a later stage. And then ultimately, we also have, and actually we did get a question about this, by the way. I'm just going to weave this in here like right now, which talks about early stage funds creating SPVs to fill out their liquidity round on a provider basis potentially in a transaction. You know, those current investors that are in there that want to increase their position use this as an opportunity, right? They definitely use this opportunity. And we do see sometimes some special opportunity funds created. That's often something that is at the later stage, for example, where folks in a series C or after a series C or D where people are looking for liquidity again and there are larger positions that are available. Sometimes, as we know, some VC funds actually go out of business.

There's potential for folks to essentially be able to buy in. And we also have crossover funds, right? We've got folks who are coming from the public company side and are seeing opportunities in these late-stage companies that are saying, “Hey we'd love to be part of this party again and actually come in before this company is going to get acquired, hopefully, with a big multiple or it's going to go IPO.” Those are all possibilities. There are also sometimes, in rare circumstances, situations where a company does actual buybacks and redemptions. We don't see that very often but those are broadly speaking, so those are the folks who are interested in this particular process. Maybe, Kevin, do you want to talk about the next slide, which essentially also has some numbers from your side?

Dave: Kevin, it hits right on one of our questions too. People wanted to know who gets to participate in the sales?

Kevin: The main group that this is geared towards are your current employees. More times than not a program is going to be structured around that, giving some of your existing employees some liquidity. There's also the bucket of early investors and founders and then ex-employees as well. In many instances, all three are allowed to participate. There are also different rules that pertain to each of those eligible selling groups, right? One of the things we see when eligible employees are allowed to sell that, they're going to sell between 10% to 20% of their vested equity, they're going to be allowed to sell that amount. For your founders, early investors, oftentimes, it's maybe just 1% to 3%. Obviously, that dollar amount can be much larger.

And then for your ex-employee group, a lot of the time, we see the rule of kind of the all or nothing used where if ex-employees are going to be invited to participate, they're going to have to sell all of their equity or they can't participate at all. And the driving factor in that is to, you know, hopefully get them off the cap table especially maybe some of the smaller shareholders, you know, in an effort to clean that up. So, generally, we see, certainly, when all three are invited, sometimes smaller programs for just those kind of block sales for the early investors and founders, but usually, this is being driven by the fact that a company wants to give their longstanding employees some liquidity.

Dave: We've, talked about employers and talked a lot about some of their motivation. I think the next slide really puts it in one concise place—why do a secondary? And I think some of the reasons there are very obvious, Daniel touched on a bunch of them, Kevin touched on a bunch of them. But I think it's useful to go over it in one concise place. You know, companies are interested in doing secondary transactions for a number of reasons. If they're aiming to go big, a ton of motivation at the company is to keep people rolling in the same direction.

And one way you do that is providing appropriate incentives, helping people actually realize those incentives. And a big part of the incentives for employees at growing private companies is often their equity awards. And so if you're looking to aim big and grow, you want to make sure that you keep employees in their seats. Oftentimes at these young companies, you may be paying market rates or below, but you're really working hard to give these employees something additional to stay on their feet. And these liquidity programs can be very, very important for the company. It can also help consolidate the cap table. Oftentimes, when a new investor comes into the company, especially if it's a strong company and a big fund, they're looking to own a certain percentage of the company as they come in and the company may not be willing to sell that investor as much of the company at the price that's negotiated as the investor would like to buy.

Sometimes, one way to make up that gap is to run a secondary program and get the buyer a greater ownership stake in the company. On the employee side, it's pretty easy to see why employees can like a secondary sale. Largely, it's financial diversification, it's actually realizing some of the benefit of their incentives. What I've seen in a lot of my clients when they do secondary transactions is there are personal milestones. And a lot of these folks could potentially make more current cash in other jobs working for larger or public companies. And in order to bridge that gap, to buy a home, put your kid through school, whatever the case may be, having this liquidity is really important. And so that can be very, very valuable. It's all about aligning incentives, and you'll see as we talk a little later in the presentation, that that's a big part of how you structure the program. There are a number of legal considerations and other considerations we'll talk about a little deeper into this. But keeping those motivations in line and keeping everybody at the table aligned on why we're doing this and where we're going is incredibly important. There's also a pool of capital out there that people are trying to put to work. And so the next slide, I think hits on where you're seeing a lot of the participants that you see in secondary transactions coming from.

Kevin: It's certainly grown, right? It's grown quite a bit and the landscape's evolved. VC predominantly but, Daniel, you were talking about those crossover funds, private equity, you can think of the sovereign wealth funds like the SoftBanks who are obviously investing in a lot of companies and investing just absolutely crazy amounts of money. It's been a pretty impressive landscape. And that is one of the reasons actually why we have begun to introduce some of these buyers to companies over the last year, which is something we're doing a little bit at Second Market with a company looking to potentially get introduced to a new secondary investor. The pool of these investors over the years has grown and we have close relationships with many of them that we're able to introduce them and if the metrics make sense, they will participate in a secondary with that company. But, it certainly has evolved a lot more. We're actually seeing a lot more hedge fund activity as well. That's actually grown in the first half of 2018. We expect to see that trend continuing.

Daniel: People are generally looking for returns and there's just a dramatic amount of money that's flowed into private investments and that's everything from sovereign wealth funds to mega funds. I just saw today that SoftBank is in talks to raise another $100 billion fund. And with all that private capital and crossover investors...we have a number of crossover investors that we represent that are allocating more and more in private investments looking for greater returns. That puts general pressure on the ecosystem, I think, and so I think that there's a lot of folks that used to be able to get into deals that they can't necessary get into and [there are] new folks at the table. It's also driving a real interest in this secondary market and creating a big capital pool out there to allow a secondary market to exist. Daniel, would you mind talking about how the dance is actually done?

We've talked a lot about what a secondary is and why you might do it and who might participate. It would be useful, I think, to talk about how it's actually accomplished.

Daniel: And we will talk a little bit later about one-offs versus tender offers, but let's talk about tender offers. When we talk about tender offers, we typically differentiate between issuer tender offers or company tender offers and third-party tender offers. And in both of those situations, of course, you can imagine that valuation considerations are the big part of it. We've spent a lot of time over the last, I don't know how many years now that we've had 409A, but I think it was after Tyco and after the Enron scandal, since 2005 or something like that. We've dealt a lot with complying with 409As, looking at 409A, also in the context of these types of transactions. And without going into too much detail, because I'm not a tax attorney and I'm going to get hit over the head by one of my tax partners if I dive too much into this, I can tell you that the discussions around what is the fair market value or what price these tender offers should get priced is a big issue in the realm of 409A valuations.

In the 409A world, essentially what needs to happen is that deferred compensation complies with the section 409A and ultimately has a real impact on option pricing and deferred compensation in the company. So therefore, those valuation considerations are part of it. And, again, without diving too much into it, the question is, is the tender offer made at what we would call fair market value, or is it essentially determined in line with the last section 409A valuation, or is it determined without a regard for lack of marketability? Are you using the last preferred price, for example, in the last financing? That's often done by the way and it's a big question. Of course, is that the right price?

Especially if you're buying stock in a tender offer for common stock from founders, they're selling common stock, so the question is how should that be priced? And, ultimately, when you talk about these types of things, there's a ton of accounting implications and tax implications on those strategies. But when you're dealing with that on the company side, you're sort of in control, if you will, or at least management is much more involved, the board is involved, and ultimately has a lot of say over those types of strategies as an issuer tender offer. That's of course a little bit different when you have a third-party tender offer. You still have the same issues, really have exactly the same problems and questions as to whether or not the common stock, for example, should be priced at the preferred stocks sold at last financing or something like that.

But that is where you have to figure out, when you're running a third-party tender offer, how you involve the company itself. Because, for all kinds of reasons, because they may be disclosed (we'll get into that a little bit later, there are disclosure issues and a whole host of other confidentiality questions around what kind of data is public when dealing with private companies). And that's, in broad strokes, just the difference or bifurcation, if you will, of the two types of tender offers. And I thought maybe Kevin, this would be a good segue for you to talk about what you guys do, for example, as a platform because, of course, this is the kind of stuff that you dive into very deeply and, of course, streamline that and help companies with these types of transactions.

Kevin: Just one thing, again, regarding structuring of transactions and 409A; again, I'm certainly not an expert on this and we always tell companies to rely on their counsel and any external tax experts on this stuff. But in the structuring of a tender offer, we see it's one of two ways, a company repurchase or a third-party. Generally, rule of thumb when it's a third-party transaction, it's considered more of an arm's length approach and doesn't have as much impact on the 409A valuation. We generally see, as far as pricing goes when companies are determining this, usually, it's at a discount to the last preferred round. Let’s say it can be anywhere from 10% to 20%. It's actually a lot of times also driven often on when a company might consider going public. If a company is closer to an IPO, it's generally under 10% or less range. And if a company is probably two plus years out, it's generally going to be 20%. But those are just some of the things that we've seen over the years, I think, that provide some helpful context. So when companies are going to run this, you were talking about the structuring and we essentially build this product really at the advice of lawyers.

I think that a lot of the feedback we're receiving from lawyers, when you guys are running these transactions, is that once you get past a certain number of shareholders, maybe like 30 or so, the process becomes a bit cumbersome. So, we've created the technology that essentially streamlines that whole process where a shareholder can access our portal, see all of their eligible holdings and see what they're allowed to sell and basically go through a workflow where they just have to fill out their information. They can sign any of the documents and disclosures via DocuSign. And also, in addition to that, act as pay agent in these deals. We have a registered broker-dealer license so we can handle the funds as well. But it's all about symmetry of information. I know we're going to talk a little bit more of the disclosure stuff later but, it's all about the symmetry of information between the buyers and the sellers. And that's what having a platform like this has really helped from the company perspective and also from the legal perspective. One of the great things about private tender offers, I think, and Dave and Daniel you would probably agree is that, they're pretty easy to run from a legal framework standpoint. I think that's why they have been so popular and why the popularity has grown. You know, once a company comes to a price point of what they're going to offer their employees, then it's basically set and they're going to determine who can sell what and then we can run with it.

Dave: That's great. Thanks, Kevin. Taking a step back and I'm sure 99.9% of the audience understands this already, but we've been talking about, and we'll go into, when a secondary sale is really a tender offer and when it is not. Like so many things in the law, it's legally vague, and depending on which jurisdiction you're in, there's an eight or nine-factor chart to determine that. But we have, up until this point, been primarily talking about things that are tender offers and the tender offers that we've been talking about fall into two general categories—both based on who the buyer is, just to make sure that we're all on the same page here. And that buyer, if it's a third-party, so not the company, that is one type of tender offer. And the company or one type of sales transaction. And if the company is a buyer, that's another type of transaction and they each have their own nuances that we have to consider. And so, like all things that touch the legal sphere, it's a lot more complicated than it may appear on the surface. One of the things that Daniel talked about was the 409A valuation. And the 409A valuation, for those that don't know and if it wasn't clear earlier, that's really establishing the fair market value typically of the common stock and that is used for granting future awards.

So you're concerned about that fair market value and the impact of a secondary sale on that fair market value, both because it has tax ramifications for the sellers and the transactions and also because it has implications for future awards. The fair market value and the sales [SP] price can also have implications for the IPO, and Kevin alluded to that when he was talking about the discount. Ultimately, when you're ready to go public, the SEC in particular, is going to look back and make sure that you took the appropriate compensation charges but also that your stock and the stock awards throughout the history of the company have been appropriately priced. The pricing of the secondary transactions can have a big, big impact. And just quickly, for example, especially if the company is purchasing or another person that has an interest in the company is purchasing, if you're purchasing for a value greater than the fair market value, that difference is likely compensation.

I'm just waiting for the door to open in the conference room I'm in and having one of our tax attorneys come tackle me because I'm talking a little bit out of school here. How you account for the part that's not compensation also depends very much on a number of factors and whether you can reduce the taxable portion by your basis—is it a dividend or, whether you can take capital gains. There are a number of factors there. We're going back to this 409A valuation point. The additional element of the valuation is if I'm selling shares and there are lots of good reasons why buyers may pay more than what we believe the fair market value is and the reason they may do that is they already have an interest in the company.

The fair market value is supposed to be what an average buyer in a third-party transaction would pay for the shares.

So that isn't necessarily reflective of this transaction. But if you do have a transaction that falls outside of what your historical 409A have, besides the tax implications, it can have an impact on your fair market value going forward because if you have third parties, they're willing to buy at a price, it could be indicative of a new fair market value. So you want to work very carefully with your counsel and also with your accountants and valuation experts to make that determination. We're going to get into a couple of slides later. You know, what's really important about the offering parameters.

But, in general, the tender offer itself, you have to think about how big it needs to be to attract interested parties. That's very important. As Kevin mentioned, the parity of information third parties have and the role that the company plays in providing that information is also very, very important because the disparity in information can lead to security flawed problems and potentially can be fraught with anti-fraud issues that the company certainly doesn't want to be in the middle of. And buyers and purchasers want to go on their merry way after the transaction is done. And usually, the thing about a private company is usually once these transactions are done, the outcome of the company isn't known because the price is not made by the market every day. So somebody's expectations are usually not met in the transaction. And some people have buyer's remorse, some people have seller's remorse. It's important to really have a parity of information so that at least you can say that everyone made a decision with the same types of information.

And as you can imagine, that becomes much more challenging in the case where the company is buying because it inherently has all of the information and the sellers don't have as much information by definition unless they're on the management team. We talked a little bit about the sellers, who will almost certainly have to pay tax on the gain. There are potentially some other factors there like the next factor, qualified small business stock may put in how much tax they have to pay. I alluded to earlier whether you can use your basis or not, whether you've held the shares long enough. Many times in secondary transactions, you'll have action holders who are exercising in order to sell. Obviously, they will not have met the long-term capital gains holding period. So you really want to think through all the various issues that will impact outcome and if you're doing this primarily for an employee based reason. You want to give your employee some liquidity.

You really want to make sure you understand and analyze the situation so that you can appropriately set the expectation because there's nothing worse than telling the employees that you're doing this great thing for them, doing something that's great but having set the wrong expectation and having them be disappointed nonetheless is really not the outcome that anybody wants. Certainly, redemptions by the company can have an impact on whether or not the company is able to issue qualified small business stock going forward. And without getting into the details to qualify, small business stock, as many of you will know, has, if you qualify and if you hold it for a long enough period, it has very beneficial tax results including an exclusion of all the gains in certain cases.

And if you impact the company, if you damage the company's ability to sell qualified small business stock, you may actually change who wants to invest in the company because that tax benefit can be material. It has its limits but it can be material. Also, if the third party is buying directly from a seller, whether or not the company can issue qualified small business stock, the stock that the seller purchases will not be qualified small business stock. And the seller, if they sell over a certain portion of their stock, may change the character of the stock that they actually hold as to whether it's qualified small business stock or not. And then the last thing, I'd say what else is really important and there are a number of other things that are important. But the thing that is worth talking about here is you have to understand what transfer restrictions there are on the securities that you're proposing to have involved in the transaction.

And often times, in most venture companies, at least the company will have a right of first refusal often even through the auction pool so it doesn't have to be a large stockholder. But the larger stockholders will almost certainly be party to some sort of right of first refusal and co-sale agreement that allows the company first and the investor second, often to purchase the shares that a third party might want to purchase then also have a co-sale right so that they could sell into the sale. Managing your way through the process and setting up all those things is incredibly important to do. With that, then, I thought, Daniel, it might useful to talk a little bit more about what a tender offer is and you can contrast that, potentially, to kind of one-off sale or things that don't qualify as tender offers.

Daniel: And maybe back to what you just talked about, the last item about transfer restriction, clearly, that is a very big issue, if you will, for founders. But as you said, not only for founders, often also for early employees, stockholders, like 1% stockholders and sometimes even the optionees. A lot of option plans actually require an exercising employee to sign or to be part of a right of first refusal and co-sale agreement. Going through that process can be, sometimes, pretty tough especially if there's no process that's been put in place. What Kevin talked about earlier is like actually putting processes in place is critical to some extent. Because if it's the first time the company actually deals with this and nobody has looked at the provisions of how ultimately a founder can sell and what kind of processes they need to go through, notice requirements, etc., it can be very jarring to say the least and can actually have exactly the opposite effect of what we just described of, trying to have talent retained and people be happy. But let's talk about what a tender offer is.

The tender offer is an offer to buy. Tender offer is really an offer that's made by either a person or an entity to purchase, broadly speaking, securities of a company, right? And those can be purchased directly, and we would typically say in that tender offer scenario, directly from the holder of that security—of the security of the company. If you will, that's really what the tender offer is. You're going out, you're saying, “I'm willing to buy these shares from you, stockholders.” And the securities law implications here that we've dealt with, and that we've been dealing with in private companies, are really that if you're going out and doing that broadly and actually talking to a broader group of people, it is not really a one-off transaction where you negotiate privately with one founder on the particular parameters of the transaction. But rather, you're really going out and trying to get interested sellers and ultimately, of course, you have to set some sort of parameters of what price you're going to buy, of course, but for how much? What's the max? What's the s ultimately top out volume of shares you'd be interested to buy? And you have to comply with particular regulations, of course, around that as well because if you are essentially doing a tender offer, we're still in the realm of what we call the anti-fraud provisions or 10(b)5, which essentially means that if there are material facts or if you're omitting essentially material facts that a buyer should know, you're actually potentially liable in that scenario because we are dealing with a sale transaction of a security.

We are still broadly in the securities laws even though we're not in a situation where the issuer necessarily is making representations. There is, broadly speaking, this anti-fraud legislation that's out there and, from a federal law perspective, something that's always looming over all of these transactions. And that means, of course, if there are particular facts that should be known, then they probably have to be on the table. That requires some disclosures and we get that but really why we are talking about this is because of this 10(b)5 liability or these anti-fraud rules. What do you have to do? You have to comply with specific timing rules. And you have to essentially leave open the offer for at least 20 business days. And that means business days. It means not 20 [calendar] days, but business days. And sometimes the calculation of those can be complex because there may be some holidays in between, or weekends etc.

You do actually need to calculate out what that 20-business-day rule is and be very clear that you want to be more conservative than not to make sure that it is really 20 business days. And then, of course, there are potentially material changes or certain things that have to happen during that 20-day business period where you may have to have some sort of an extension because there are some very important factors that have happened. Company got sued on a patent, for example, or some other things that ultimately mean that their 20-business-day rule would be extended beyond just the actual 20 days. And then of course, as part of a tender offer, you also have to figure out how to actually deal with the settlement of the transaction and how you deal with the payment.

This is, of course, why Kevin and NASDAQ Private Market etc., has built in a very great platform that allows you to do all these things because that can be administratively quite a big headache and because you do need to have and facilitate what we call prompt payment. And if prompt payment doesn't happen, then essentially the tender offer could fall apart.

Dave: Kevin, given that we've got only a few minutes left, I think it might be really helpful to answer a few questions around parameters and it fits right into this next slide here. Who gets to sell? What do you see when the interest is too high or too low? Those typical parameters. And we had a question about if you have to provide equal access. The answer is probably not, especially if it's a third-party transaction. But the real answer is much more nuanced than I'd say you want to set, at least in our experience, parameters that while everybody may not like the parameters, you're not cherry-picking individuals out of the set. You've set parameters, if you qualify within the parameters, you're going to be included and if you don't, you don't, especially when it gets to a tender offer. But, Kevin, I'll turn it over to you for a few minutes.

Kevin: Back to your point of equal participation, your answer is correct as far as it's entirely up to what the company wants to do. There are times when we do see different offer prices for different groups of folks. When a company is considering doing one of these transactions, there are a lot of different factors that go into it and a lot of different factors that vary between a buyback versus a third party. But you want to get as many folks, hopefully, to participate as possible. And we actually, sometimes will see, before an offer is made, some companies that will actually reach out to eligible sellers who obviously they deem as eligible sellers especially like the large shareholders. And they'll reach out about a potential offering to pique their interest to see if they would consider selling.

Now, it's a great way to gauge what level participation may be. You have to be very careful not to trigger a formal offering. So when a company does this, you've got to be very cognizant of talking about what the exact price is going to be because obviously if you did that, then it's going to probably trigger a formal offering. But there are a lot of different factors that go into, again, who they want to participate and how much they're going to sell. Just one of the things I'll dive into a little bit deeper if it's okay with you guys is the structuring of these and the driving factors around them.

We were talking about third parties. There are two different structures, though, where you consider a buyback. The first would be just using cash in your balance sheet, which is a luxury, obviously. It's simple in structure. But, not every company obviously can do that. But if a company uses their existing cash to purchase shares from the shareholders then the main benefit is that they have complete control, right? There's no third-party involvement. You know, price usually then requires the most consideration since the company is not negotiating with a third party and is left to determine the appropriate price to be offered but certainly some companies do this.

Then the other context of a buyback is you're using right fundraising proceeds from, like, a primary. So they'll usually, you know, allocate a certain portion of that after they raise a primary to do a secondary. And again, they're going to maintain full control over the offering without using, you know, that balance sheet cash. And so, you know, companies that will utilize this method usually incorporate the amount of capital needed to fund the tender between the preferred share price, paid to the company in the primary round, and then the per share price of the common stock paid out to the shareholders. In this case, common stock typically trades at a discount to the latest preferred. And third context in a third-party tender offer you have one or two buyers who are buying the shares directly from the company-approved list of eligible sellers, we see roughly about a half of our transactions as being third-party. And the main benefit of this type of arrangement for a company is that it streamlines the whole liquidity process, right? Instead of having to raise money prior to a tender, the company can rely on the buyers to directly purchase from the approved seller list. Depending on what you want to do and which structure is preferable, there are not going to be a lot of different driving factors, right? If you're a profitable company with consistent cash flow, again, which is the luxury, you might choose to utilize the cash in your balance sheet to repurchase shares, but not everyone has that. So the great thing again is that there's so much capital on other markets that a lot of companies are luring in secondary buyers to purchase. And also raising huge primary rounds where maybe they're raising $100, $200 million and they're allotting $20 or $30 million to do a repurchase.

Dave: Thank you, Kevin. You can see that the motivation and what you're trying to accomplish with the secondary really drives the parameters. And you have to do a lot of groundwork to figure out who's going to be affected and whether it will achieve what you want. I think we're at the end of our time. As you can see, we can talk about this for a long time. It's a complicated area. It sounds simpler on its face, but certainly worth getting professionals involved to help you understand it.

That concludes our program for today. Thank you very much for joining us.

For more information, please contact:

Dave Gammell
Partner, WilmerHale
+1 617 526 6839
David.Gammell@wilmerhale.com

Daniel Zimmermann
Partner, WilmerHale
+1 650 858 6034
Daniel.Zimmermann@wilmerhale.com