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Private Company Liquidity: CEO and CFO Considerations
A Guide to Secondary Transactions
Over the last decade, there has been an increase in ways for holders of private company securities to sell those securities to investors. Unlike an initial public offering (IPO) or a financing where the company sells shares of its own stock (primary sales), the market for private company equity sales, referred to as the “secondary market,” allows sellers to liquidate their holdings without proceeds going to the company whose stock is being sold. The rapidly growing nature of these secondary markets has led to many sellers and an increasing array of alternatives for those sellers to achieve liquidity. Despite being an established market, the information available to buyers and sellers is limited when compared to the market for publicly-traded stock and therefore the market is characterized by significant opacity as compared to public exchanges where US federal securities laws, disclosure requirements and investor rights are well understood.

Private companies understand the steps and potential impact of issuing equity to investors in a primary sale either privately or publicly as these transactions are customary and well-known (i.e., in a private preferred stock financing or an IPO). Sales of shares in a secondary market, on the other hand, introduce unique challenges that are not well understood. This publication outlines certain valuation, accounting, tax, regulatory, legal, and human resources related considerations that should be carefully considered by private companies whose shares are sold in a secondary market.
Concerns

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**Rise of the unicorns**

Unicorns have recently dominated the media’s coverage of venture-backed company financing transactions. The valuations implied from such transactions have garnered widespread attention as entry to this exclusive club requires a post-money valuation of at least $1 billion.

Accompanying these spectacular valuations are invested capital figures reaching well into the hundreds of millions of dollars for a single company. Most of these media stories also carry a comment regarding the choice by many of those companies to “stay private” for some extended period rather than to go public. That dynamic—whether by choice or not—is not limited to the most high-profile companies. In fact, the average age of all venture-backed companies going public has progressively increased over time. From 2006 to 2016, the average age moved from 5.1 to 7.6 years, an increase of 49%. Despite solid IPO markets since the crisis of 2008 and 2009, relatively few venture-backed companies have successfully priced an IPO over the last seven years.

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**Figure 1—Venture Capital exits since 2006**

Source: 2017 National Venture Capital Association Yearbook

**Unicorns:**

*Average age of 9.1 years (range 2–29)*

Source: Wall Street Journal and Dow Jones VentureSource as of March 31, 2017
Pent-up demand for liquidity

With private companies staying private longer and an IPO often many years away, the desire for founders, executives, and employees of such companies to achieve, at a minimum, partial liquidity has increased. Many factors contribute to the pent-up desire to sell shares, including milestones in life such as buying a home, paying a child’s tuition or caring for a parent. Further, changes in management with the early departure of a founder or other senior executive is a commonplace occurrence in high-growth companies. These situations, as well as other tax and estate planning needs, have contributed to the desire by individuals to achieve a partial liquidity event through a secondary sale.

Secondary market transactions involving shares of private companies had been increasing significantly in recent years, with Nasdaq Private Market facilitating secondary transactions totaling over $1.6 billion in volume in 2015 alone\(^1\); however momentum slowed in 2016, with Nasdaq Private Market facilitating only $1.0 billion in secondary transaction volume last year.\(^2\) There was a slowdown in overall US capital markets activity in 2016, which was also seen in private venture rounds and initial public offerings, leading to a decrease in secondary transactions.

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**Who are the players?**

Our focus is on the sale of private company securities held by founders and/or employees, and the valuation, accounting, tax, regulatory, and legal considerations stemming from secondary market transactions. However, the secondary market includes a broad range of potential sellers and buyers. Below is a brief summary of these participants and their potential motivations:

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<table>
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<th>Buyers</th>
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<td>Existing investors</td>
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<td>Gain exposure to high-growth private companies pre-IPO via private share exchanges</td>
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<td>Company</td>
<td>Reduce dilution and promote employee morale through assisting in liquidity</td>
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The challenges of navigating these opaque secondary markets include identifying the right partner, understanding the potential risks, and properly handling the transactions from an accounting, tax, and legal perspective on a personal and company level.

Secondary buyers can be existing investors in a private company and/or dedicated secondary funds seeking stakes in private companies with a specific mandate to purchase founder and executive shares. These existing investors and dedicated funds bring several key benefits to the table that are not always present with other options:

1. A dedicated fund or venture fund is likely to be well known in the market, and their reputation provides a level of comfort to the venture-based company’s board and management team.

2. Having depth in the industry of the seller, as well as an appreciation for the nuances of the transaction process, enables a fund to close in an efficient manner.

3. Structuring expertise will be resident with an institutional buyer, creating more flexibility for the sellers.

4. Having existing funding in place fosters larger transaction capability and certainty of a close, as well as the ability to execute multiple purchases over time.

5. Dedicated secondary buyers have established processes to ensure confidentiality, a critical factor for companies exploring these types of transactions.
Secondary transactions in focus

Recognizing there is a myriad of permutations of secondary transactions, we have highlighted in the graphics below three central structures that are prevalent in the market.

Traditional transaction: institutional buyer makes outright purchase with cash

The first structure involves the simplest form of secondary sale where an executive sells shares to a dedicated secondary fund in exchange for cash. This type of transaction can often be executed quickly given the lack of complexity, little requirement for company involvement and zero impact on the company’s capital structure; however, certain issues should be considered such as a company’s consent requirements or right of first refusal on the shares or other co-sale rights that might exist. Even in light of these issues, this structure offers the simplest sale alternative.

Traditional transaction: company makes outright purchase with cash

The second structure is similar to the first, except that the buyer is the company. Unlike the first structure, the company is actively involved as a result of being a participant in the transaction.
The third structure is more complex than the first as the purchase is not fully completed up front when the seller receives proceeds. Instead, the buyer loans cash to the seller and the loan to the seller is secured by the underlying shares, which could result in a variable number of shares being used to settle the obligation. This approach can bring similar benefits to the outright purchase alternative from an institutional buyer, such as a lack of impact on the capitalization structure of the company and little to no need for company involvement. Additionally, it can help the seller defer taxes and potentially limit the number of shares being delivered. However, it can also result in incremental shares being delivered by executives if the company does not perform up to expectations making this structure higher in leverage and risk to the seller. One further consideration includes proper structuring to avoid a constructive sale if a goal of this method is to delay income taxation. Additionally, loans could have additional adverse accounting consequences if the buyer is an economic interest holder or viewed as acting on behalf of the company.

These three relatively simple structures create the basis for a surprising number of permutations and resulting issues that companies and their employees must consider to ensure smooth execution and proper handling from an accounting, tax, and legal perspective.

For example, from an accounting perspective, once the executive decides to sell, will the accounting change if the existing investors decide to participate alongside the dedicated fund (i.e., does the transaction contain a compensatory element)? If the first secondary sale is repeated by a second, third and fourth sale over time, is the accounting the same in those subsequent transactions? How much involvement can the company have in the transaction? The accounting, tax, and legal implications for these transactions are complex and require careful consideration of the facts and circumstances.
First question—Valuation?

Typically management is focused on a few questions related to valuation:

1. What value will I receive for stock that I sell in a secondary transaction?
2. How will this value relate to my company’s last round of institutional financing?
3. What if the sale price is higher than the most recent independent valuation performed for purposes of compliance with US Tax Code Section 409A?
4. Will this sale impact my company’s future Section 409A valuations?
To illustrate the key elements of a Section 409A valuation and the potential impact on such valuations on sales of founder and/or employee shares in the secondary market, it may be helpful to evaluate the progression of a theoretical Section 409A valuation over time (see Figure 2).

Private company valuations are performed using the guidance of ASC 820, *Fair Value Measurements and Disclosures*, and the AICPA Practice Aid on Valuation of Privately Held Company Securities Issued as Compensation. Valuations help private companies support reporting assertions such as tax defense under Section 409A and the determination of the fair value of common stock for accounting and financial reporting purposes under ASC 718, *Compensation—Stock Compensation*. Companies must determine for themselves the cadence of obtaining a Section 409A valuation. If the company’s growth has been moderate and a liquidity event is years away, companies may choose to obtain the valuation annually. However, when the growth of a company is very strong, the company is selling stock or raising new financing and/or a liquidity event is on the horizon, performing Section 409A valuations more often, typically quarterly, may be more appropriate.
Section 409A of the Internal Revenue Code (IRC) imposes an additional income tax of 20% of the amount deferred (and an underpayment interest charge) at vesting on deferred compensation that does not meet its requirements and is not exempt from its provisions. The term “deferred compensation” is broadly defined for this purpose and may include non-qualified stock options (but not incentive stock options). A non-qualified stock option generally would violate Section 409A’s requirements if required to comply with them because the option may be exercised at any time and therefore would violate Section 409A’s requirement of a fixed payment date for deferred compensation.

However, most non-qualified stock options may be exempt from Section 409A’s requirements if they have an exercise price that is not less than the fair market value (FMV) of the stock on the grant date. To demonstrate that the exercise price meets this requirement for stock that is not publicly traded, the company must be able to show that the grant date value was determined by the reasonable application of a reasonable valuation method. A company may obtain a presumption that the value chosen is correct if the price is the result of a valuation performed by an independent third-party. There are other approaches that may be used to obtain this presumption, but they are not generally used. The stock price obtained from the independent valuation may be used for up to 12 months, provided that there is not a material change in circumstances that would call it into question.
Pre-IPO venture-backed companies generally raise equity through the issuance of preferred stock as opposed to common stock. Executives and employees, on the other hand, are typically granted share-based payments in the form of common stock as part of their compensation packages to attract, motivate, and retain those individuals. Every executive would like to sell common stock as close to the preferred valuation as possible, but they may also recognize a natural gap should exist due to differences in the preferred stock’s superior rights and obligations (e.g., liquidation preferences and conversion features). The sale price of common stock might be greater than the common stock value implied from the most recent Section 409A valuation. This could happen if the most recent Section 409A valuation is stale and the company has shown growth or met key milestones since that valuation date. In those circumstances, recent secondary trades could be a consideration in any new Section 409A valuation that is performed and in setting the exercise price of any options granted before the updated Section 409A valuation is completed.

The SEC has historically focused on the relevance of transactions in the valuation of the company’s common stock and what weighting, if any, should be placed on secondary transactions when valuing common stock.

ASC 820 established a fair value hierarchy of Level 1, Level 2 and Level 3 inputs, with objectively verifiable information carrying more weight for accounting purposes. Secondary market transactions are generally considered Level 1 or 2 inputs. Valuation techniques should maximize the use of relevant observable inputs (Level 1 and 2) and minimize use of unobservable inputs (Level 3), which would typically include discounted cash flows and relevant multiples.

The transaction price paid in a secondary transaction would typically be weighted significantly when estimating the fair value of a company’s common stock. This is due to the fact that arm’s length transactions are generally viewed as the best indicator of fair market value. However, the facts and circumstances of any secondary sale will determine its impact on subsequent Section 409A valuations, and the corresponding impact on the exercise price of future stock options granted and/or the valuation of share-based payments to employees, including employee stock options and restricted stock.
Certain common considerations in these transactions include:

1. **Motivations.** What were the motivations of the buyer and the seller? Are there strategic reasons for the transaction? Is it being used to consolidate ownership or gain control? Certain parties might be willing to pay a premium over fair value for some other strategic benefit. How involved is the company in the share sale? All of these questions may impact valuation.

2. **Process.** A secondary market transaction is orderly if there is adequate exposure (time) on the market and exposure to multiple buyers. Whether buyers and sellers are independent third parties or insiders can impact valuation, accounting, and tax treatment. If a secondary market is the principal market for current employees, with repeated transactions around a given price level, the presumption is that this reflects fair value (unless other factors such as strategic investors are present).

3. **Size/Volume.** Larger transactions may be more indicative of sophistication, access to company data and material due diligence by a buyer. Similarly, a higher number of trades by multiple independent third parties would likely provide greater support for fair value.

4. **Timing.** The further removed a secondary market transaction is from the date of the Section 409A valuation, the less relevant the implied value becomes.

5. **Information.** Private companies do not have the same disclosure requirements as public companies, although in some secondary sales transactions management does provide financial information to potential investors. Limitations around information, particularly when associated with limitations around the number of buyers and sellers may be a relevant consideration when assessing how much weight to apply to secondary transactions. However, even if buyers and sellers of secondary transactions have less information than company management, valuation practitioners need to keep the accounting fair value hierarchy in mind when determining how much weight to place on such transactions relative to other valuation approaches such as discounted cash flows and other Level 3 inputs.

6. **Structure.** Use of structured pricing mechanisms such as a loan structure or other mechanism where upside is shared may alter the impact on the valuation.
Second question—What else?

Accounting

Private companies should carefully consider the accounting implications resulting from sales of shares held by founders and/or employee shares in secondary market transactions. Two key determinants will influence whether the company should recognize compensation expense as a result of such transactions.

Did the transaction price exceed the current fair value measurement?

The accounting for secondary market transactions involving founder and/or employee shares may involve two elements if the transaction price exceeds the fair value of the shares at the time of the purchase: (1) a stock purchase, and (2) compensation paid to the founder and/or employees equal to the amount of the transaction price in excess of fair value. Making this determination requires an understanding of multiple factors, including the company’s level of involvement with the transaction and the reasons why the buyer paid an amount that exceeds fair value.

If the transaction price does not exceed the fair value of the shares, then the purchase would typically not include a compensatory element.³

³ There may be other accounting implications if a company or other party repurchases shares pursuant to a pre-existing repurchase right. Additionally, accounting implications could arise if a company develops a pattern of repurchasing (or arranging for other parties to repurchase) unexercised options or shares issued as compensation that are held for less than six months post-vesting (and, if acquired via option exercise, post-exercise). Refer to section entitled Risk of “tainting” existing share-based payment plans for further discussion.
How involved was the company in a secondary market transaction?

When a secondary market transaction price exceeds the fair value of the shares, the company’s level of involvement should be carefully considered to determine if the excess amount represents compensation for employee services or relates to something else.

If the company directly repurchases the founder and/or employee shares, the excess of the purchase price over fair value would typically be considered compensation for employee services and the company would recognize compensation expense equal to the excess amount.

However, if the company had no or limited involvement in the transaction, then the relevant facts and circumstances should be carefully considered to determine whether the transaction includes a compensatory element. A sale that is negotiated between the founder and/or employee and an unrelated third party without the company’s involvement may not include a compensatory element. A careful analysis of how the transaction arose, how the price was set, what role the company played, what level of forecast and other financial information that the company shared with the third party, whether the company was simultaneously selling shares to the third party, timing of most recent 409A valuation and any related party relationships should be performed. If not considered compensatory, these transactions should be considered in future Section 409A valuations.

It is also important to understand the relationship between the company and the buyer in the secondary market transaction. If the buyer holds a pre-existing economic interest in the company, then the buyer is presumed to be acting on behalf of the company with regard to amounts paid to employees. As a result, a purchase by an economic interest holder could be viewed similarly to a direct purchase by the company. If the transaction price exceeds fair value, then the excess amount is considered compensation for employee services, unless the payment is clearly for another purpose, and the company will recognize the compensation expense that was incurred on its behalf. This is the case even if the company is not responsible for directly funding that cost.
Economic interest holders

The participation of an individual or entity that holds a pre-existing economic interest (e.g., debt, common equity or preferred equity, as well as contractual arrangements such as leases or licenses) in a secondary market transaction involving a company’s founder and/or employee shares could impact the accounting treatment in a significant way. Such investors are presumed to be acting on behalf of the company unless the payment is clearly for a purpose other than compensation to the employees. Thus, their involvement could be viewed no differently than if the company were directly involved in the transaction. Consequently, the company could be required to recognize compensation expense for amounts paid to employees in excess of the fair value of the shares. The following are examples where this situation may arise:

- An existing investor who holds the company’s common or preferred stock acquires the founder and/or employee shares to increase their stake
- A financial investor (e.g., venture capital fund) with a pre-existing ownership interest acquires the founder and/or employee shares in connection with a stock purchase plan
- A dedicated fund establishes a program to buy shares from executives over time in successive tranches. The first purchase might be considered a “true” third-party purchase (depending on the involvement of the company). Once the fund owns shares, however, it would be considered an economic interest holder with regard to future purchases.

It is important to note that the definition of an economic interest holder is broad and does not require a minimum level of interest. Additionally, an entity does not have to own shares in a company to qualify as an economic interest holder.
The following chart outlines the key factors a company should consider when determining whether secondary transactions involving founder and/or employee shares include a compensatory element:

4 The company and/or an economic interest holder would be deemed to be directly or indirectly involved in setting any of the terms of the transaction.
5 There may be other accounting implications if a company or other party repurchases shares pursuant to a pre-existing repurchase right. Additionally, accounting implications could arise if a company develops a pattern of repurchasing (or arranging for other parties to repurchase) unexercised options or shares issued as compensation that are held for less than six months post-vesting (and, if acquired via option exercise, post-exercise). Refer to section entitled Risk of “tainting” existing share-based payment plans for further discussion.
6 In such situations, the Company would bear the burden of proof to demonstrate and appropriately support an assertion that the amount paid in excess of fair value relates to a separate, unrelated transaction or distinct good or service received. In our experience, doing so is challenging and is a ‘high hurdle’. An example of a situation in which such a transfer is not compensation is a transfer to settle an obligation of the economic interest holder to the employee that is unrelated to their employment by the entity.

Identify the fair value of the purchased shares

Does the transaction price exceed the fair value of the shares?

Yes

Was the purchase made directly or indirectly by the company or an economic interest holder?\(^4\)

No

Generally, no incremental compensation expense would be recognized\(^5\)

Yes

Did the transaction price paid in excess of fair value clearly relate to something other than compensation?\(^6\)

No

Incremental compensation expense would generally be recognized (excess over fair value)

Yes

No
Risk of “tainting” existing share-based payment plans

An important and growing consideration related to secondary purchases of founder and/or employee shares relates to the impact recurring repurchases could have on the classification of a company’s existing share-based payment plans. A company that classifies share-based awards within stockholder’s equity has concluded those awards will be settled in equity. Companies that establish a pattern of repurchasing unvested employee stock options, restricted stock or immature shares (i.e., shares held for a period of less than six months after vesting and, if applicable, exercise) are at risk of causing their entire employee share-based payment plan to be liability-classified.

As the frequency of repurchase transactions increases, so too can the founder/employee’s expectation that such interests will be cash settled by the company or an economic interest holder on an ongoing basis. As a result, outstanding share-based payment awards could become in-substance liabilities, and the company would be required to re-measure such awards at fair value on each reporting date until the award is settled, thereby introducing income volatility (and potentially more compensation expense).

On the other hand, repurchases of “mature” shares (i.e., vested shares held for more than six months) do not create risk of “tainting” other awards because the award is considered equity-settled as the holder held the risks and rewards of share ownership for a reasonable period of time before the repurchase. Therefore, companies seeking to avoid “tainting” equity-classified share-based awards issued to founders and/or employees should ensure interests sold in secondary transactions are limited to “mature” shares.
Disclosure considerations for pre-IPO companies

The issue of “cheap stock” has historically been, and continues to be, an area of focus for the US Securities and Exchange Commission (SEC). The SEC continues to request analyses reconciling the estimated fair value of the company’s common stock as of each grant date leading up to an IPO with the estimated IPO price when reviewing Form S-1 filings. If applicable, such analyses are expected to explain any material differences. Therefore, companies with aspirations of raising capital in a public offering should be prepared to defend historical valuations used for tax and financial reporting purposes if materially different from the expected IPO price.

As part of such disclosures, companies whose shares trade in secondary market transactions should be prepared to discuss how such transactions were factored into their fair value measurements. This may require a discussion of the weighting ascribed to such transactions. A company’s failure to appropriately consider such indications of value in its fair value measurements could introduce risk of challenges to its accounting conclusions and/or restatement, which could lead to a delayed IPO effective date.

Companies who fail to appropriately account for secondary market transactions involving founder and/or employee shares could be required to spend significant time resolving SEC comments. If a company failed to appropriately account for secondary market transactions, that company may be required to restate its historical financial statements if an error is material. Either situation could delay the effective date of the proposed offering, further reinforcing the importance of “getting it right” at the time the transaction occurs.

In addition, if directors, officers and/or five percent stockholders participate in a secondary sale, a company may have to disclose the transaction in its IPO registration statement as a related party transaction. Consider these key factors when determining the level of cheap stock disclosure required in the IPO prospectus:

1. Range of pricing in prospectus versus historical valuations (18 to 24 month trailing period) and relative trends (industry specific)
2. Key milestones in company’s development (revenues, profitability, key hires, etc.)
3. Timing of valuations performed (contemporaneous or retrospective)
4. Valuation approach and weighting (market approach, income approach)
5. Comparable companies
6. Discount for lack of marketability
7. Weighting of secondary market transactions
**Tax**

Depending on how the shares disposed of, as part of a secondary transaction were acquired, relevant documentation such as the employee equity plan, the shareholders’ agreement, award agreement, and any election made pursuant to Section 83(b) of the Internal Revenue Code should be examined to ensure that the employee is the owner of the shares for tax purposes and to determine the capital gains holding period. For stock acquired through an option exercise, it is also important to review the grant and exercise dates to determine the type of disposition (for an incentive stock option (ISO)) and the holding period for capital gains treatment. If loans were used to facilitate the stock purchase, these should be examined to confirm that the stock purchase was in substance a purchase rather than an option to purchase.

**Implications for employees holding stock**

For employee participants in a secondary transaction that hold pre-existing stock, if the sale price exceeds the current 409A valuation on the shares, the difference between the sales price and the 409A valuation may be either capital in nature or ordinary income (i.e., W-2 income). The characterization of this income as capital gain or W-2 has a significant impact on the applicable tax rate to the employee shareholder and also on the Company’s tax withholding and reporting obligations and availability of a corporate tax deduction.
If the gain is determined to be capital in nature, any gain or loss recognized by the employee upon the sale or exchange of shares generally will be treated as capital gain or loss and will be long-term or short-term depending on whether the employee held the shares for more than one year. But, if shares purchased through the exercise of an ISO are sold either within two years from the date of the ISO grant or one year from the date of exercise of the ISO, generally any gain up to the excess of the fair market value of the shares on the date of exercise over the exercise price will be treated as ordinary income. Any AMT taxable income that was recognized at the time of the ISO exercise is generally credited back when tax is paid upon sale of shares. Any additional gain generally will be taxable at long-term or short-term capital gain rates, depending on whether the shares have been held for more than one year.

If the gain is determined to be compensatory in nature, the difference between the sale price and the current 409A valuation will be ordinary income (W-2 income) to the employee, and the Company is required to withhold for and report taxes on this amount. The Company will generally be entitled to a corporate tax deduction for this amount.

Whether the difference between the sale price and the current 409A valuation is capital or compensatory in nature (i.e., W-2 income) depends on a variety of facts and circumstances, including who the buyer is, whether the Company has the intention of compensating employees by paying a premium on the shares, and the purpose of the transaction (e.g., outside investor desired to purchase shares and Company did not want to dilute existing shareholders, i.e., in an “arm’s length transaction”). There is no “bright line” test to make this determination, and the tax determination may be different than the treatment for accounting purposes.

**Implications for sellers holding stock options**

Option holders with vested stock options are sometimes allowed to exercise their options and immediately sell shares as part of the secondary transaction. Although we have seen options be cancelled and cashed out in these transactions, it is more typical (and more tax advantageous for ISO holders) if the secondary transaction is structured as a stock option exercise followed by an immediate sale of the shares.
With respect to a nonqualified stock option (NSO), assuming that the NSO is exempt from Section 409A, the exercise of the option and immediate sale of the shares would result in ordinary income to the service provider equal to the fair market value of the stock at the time of exercise (i.e., the sale price) less the exercise price. This ordinary income is treated as wages and subject to regular employer tax withholding and reporting. The immediate sale of the ISO shares following exercise would result in a disqualifying disposition of the ISO shares which means that the difference between the fair market value of the stock at the time of exercise (i.e., the sale price) less the exercise price would be ordinary income to the employee and reportable on a W-2, but no FICA will be due as ISO exercises are exempt from FICA, and the Company would not be required to withhold for Federal income taxes on this amount. The spread at exercise would not be includable in AMT income (as is normally the case with an ISO exercise) as the sale of shares occurs in the same calendar year as the exercise. The exercise of the ISO would also require separate reporting on the part of the Company on a Form 3921 (which is required for ISO exercises).

Other reporting and foreign shareholder considerations

In addition to the valuation considerations noted previously surrounding Section 409A valuations of common stock, companies involved in secondary transactions may also want to consider the following additional tax considerations:

- Foreign employee shareholders who are US citizens may have additional tax issues under foreign law, and may need to address these implications for US tax purposes.

- In certain cases, a buyback could be considered a dividend rather than a redemption.

- Sales of stock may require reporting of proceeds on Form 1099-B.

- Foreign stockholders may be subject to a separate backup withholding regime.

- A company’s buyback of shares may also impact whether or not the shares held by other stockholders qualify as qualified small business stock (QSBS) for federal income tax purposes.
Under section 12(g) of the Exchange Act, if a private company has more than $10 million in total assets, has a class of equity securities, and has more than 2,000 accredited investors or more than 500 non-accredited investors, the company is required to register as a public company to the SEC. However, employees holding shares as a result of employee compensation plans can be excluded from these totals. There is a burden on private companies to track the number of external shareholders, and secondary market transactions can raise the concern that the company will surpass the 2,000 shareholder limit and subject the company to the registration requirements of a publicly traded company. Executing a transaction with a single investor who is willing to buy from a group of small investors to minimize the number of investors is an effective means to control the number of shareholders in a privately held company.

The general rule under the US Securities Act of 1933, as amended is that the offer and sale of any security requires registration absent an applicable exemption. There are several legal exemptions to the Securities Act that allow for secondary sales to occur without requiring registration. For example, a private company may issue new shares to certain number of accredited investors without being subject to the registration requirements under Section 4(a)(2) of the Securities Act (an exemption for private placements) or Regulation D. However, a secondary market transaction between a seller and an accredited investor does not involve the issuer and therefore requires a resale exemption. If a transaction cannot avail itself to Rule 144, the company may have to rely on a case-law based securities exemption (known as Section 4(a) (1 ½)).

Rule 144 allows public resale of restricted and control securities if certain conditions are met. The specific conditions that must be met under Rule 144 will depend on whether or not the seller is considered an affiliate of the company. CEOs, senior executive officers and board members are typically considered “affiliates” of companies for this purpose. Sales of restricted securities are subject to an initial holding period of one year in order to avoid public registration under the Securities Act. Sales of control securities are subject to “manner of sale” restrictions. Under these “manner of sale” restrictions, the seller may not solicit buyers for the sale of the securities or prearrange buyers for their securities. The buyer must receive adequate

7 An Accredited Investor is any bank, private business development company, organization with over $5,000,000 in assets, director of the issuer, a person with a net worth over $1 million, a person with an income over $200,000 for the prior two years, a trust with assets over $5,000,000, or an entity in which all of the equity owners are accredited investors.
current information about the issuer of the securities before the sale can be made. This generally means that the issuer has complied with the periodic SEC/financial reporting requirements that most venture-backed companies already provide to their investors. In summary, the simplest way for a seller and the company to avoid violating the legal restrictions of transferring restricted stock in a secondary market transaction is to work with established secondary firms who are viewed by the SEC as accredited investors.

Another consideration is whether a tender offer has been triggered under the securities laws. For a privately-held company, if a tender offer is triggered, the sale would require additional procedures to comply with securities laws (including having the offer be made open for at least 20 business days).

Given there are no specific rules defining what is considered a tender offer, advice from legal counsel with experience in these transactions is critical.

There are three potential disclosures that may need to be made within a Form S-1 regarding a secondary sale. Transactions occurring between the company and its officers, directors, and other affiliates within the three years prior to the IPO must be disclosed in the related-party transactions section of the company's S-1. Dependent upon materiality, a third-party purchase not involving the company will need to be disclosed. While many underwriters have understandable concerns about allowing a secondary market transaction to occur during the registration period, there are certain circumstances where they have been permitted. When a secondary market transaction occurs during the registration period, underwriters typically require that the buyers agree to certain restrictions on shares. The company will also have to file an amendment disclosing relevant information about a secondary transaction.

Regarding timing of secondary market transactions, management may wish to impose blackout periods on the sales of employee stock during certain periods of time, such as fundraising, executing or discussing material transactions. Depending upon the maturity of the company, it may also be prudent to black out trading around quarter or year end to prevent incentives from becoming misaligned between the company and its employees.
Secondary sale transactions require a closer look into a few legal implications. Several states (Delaware and California) have statutory balance sheet tests limiting the amount of capital that a company may use to buy its own shares; however, these restrictions do not apply in a third-party purchase. Additionally, consideration should be given to whether or not the transaction requires a Hart-Scott-Rodino antitrust filing, which involves significant time and effort and a large filing fee, but has substantial penalties if missed. This requirement arises in a third-party purchase by an investor that already holds a substantial amount of shares in the company.

The two most common transfer restrictions impacting secondary market transactions are the right of first refusal (ROFR) and right of co-sale (Co-Sale). The ROFR provision can prevent the buyer from acquiring the entire number of shares it wants, and the Co-Sale right can thwart a seller from selling all of the shares that they would like. As part of the process of a secondary transaction, expect that the company’s board and/or its major stockholders would have to waive applicable rights to sell under a ROFR or Co-Sale agreement.

Given these challenges, and numerous other legal issues noted, it's essential that experienced counsel be hired to advise on any secondary sale transaction.
Human Resources

From a human resources perspective, it is important to consider the impact of a secondary transaction for rank and file employees. These employees may hold stock options rather than common stock and may not be fully vested. However, limiting their rights to participate in the transaction may be seen as inconsistent with the seller’s intent to maintain a culture of equality among employees and would prevent them from realizing this additional benefit from their efforts. Notwithstanding this, adding rank and file employees to the mix of sellers would generally substantially increase the number of sellers and the complexity of the administration of the sale (including the tender offer process) and potentially significantly impact future 409A valuations. Also, any increase in the exercise price for future option grants as a result of the sale would reduce option gains available to future grantees.
Conclusion

Sales of common shares by executives of private companies is a fast growing area presenting a unique set of challenges. At a minimum, these liquidity opportunities will create considerations applicable to a company’s valuation, accounting, tax, regulatory requirements, legal and human resources. This level of complexity requires comprehensive advice, legal and financial, and acknowledgement of a timetable that will, on average, be measured in months. The alternative could result in delays to future liquidity events, personal tax impacts and negatively impact employee morale. With the right level of preparation, secondary sales can be managed to create win-win events, provide needed liquidity to employees and executives and help prevent surprises for the company or management in the future.
Administrative challenges cost of an IPO, significant costs of being public.

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At a glance

PwC’s Deals practice

A publication from May 2016

Need to be addressed.

Additional to the financial costs of being public.

Companies are getting cost to be a significant

The JOBS Act does not appear to be a significant

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Potential investors company is viewed by

Impact the way your non-GAAP measures can

Understanding of how on a thorough

A successful IPO depends

High-yield debt offerings upcoming

High-yield debt issuances Engineering & Construction: No IPOs priced, 1 high-yield debt issuance for $325m

Slightly from last week with 10 companies seeking to raise $4.1 billion.

Oil and gas sector, with seven issuances accounting for nearly $5.0 billion. The forward calendar fell 17 issuances raising $9.4 billion. Continued relative strength in oil prices helped drive refinancings in the

High-yield debt market:
The US high-yield debt market had its most active week in six months with highs on Wednesday.

Broader equity markets, the Dow Jones Industrial Average and the S&P 500 both reached new record

Slow with two new companies filing and three IPOs expected to price before the winter holidays. In the

Including Athene’s $1.0 billion mega-IPO, the second largest deal this year. Overall market activity was

As 2016 begins to wind down, the US IPO market saw four IPOs raising $1.2 billion,

Summary:

IPO Market:

17 high-yield debt issuances for $9.4bn

4 IPOs priced raising $1.2bn

For companies considering an IPO or high-yield debt offering, it is useful to understand how quickly

Activity. Please reply to this email if you would like to subscribe others to this weekly email.

This snapshot of the IPO and the high-yield debt markets in the US includes issuances for the last

Week ending Thursday, December 8, 2016
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What comparables should I look at for my IPO? How will my company be valued? How much capital do I need to raise?

How do I develop and prepare my SEC financial statements and disclosures?

How do I improve my budgeting, planning, and analysis function?

How do I improve my capital structure and evaluate financing alternatives?

How do I prepare to comply with SOX?

How do I manage the proceeds from my offering?

How do I develop my jurisdiction and domicile tax plan?

How can I accelerate my IPO closing process?

How do I benchmark, plan, and design my executive compensation plan?

How do I meet my new governance requirements?

How do I develop my executive compensation plan?

How do I improve my capital structure and evaluate financing alternatives?
Acknowledgments

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