



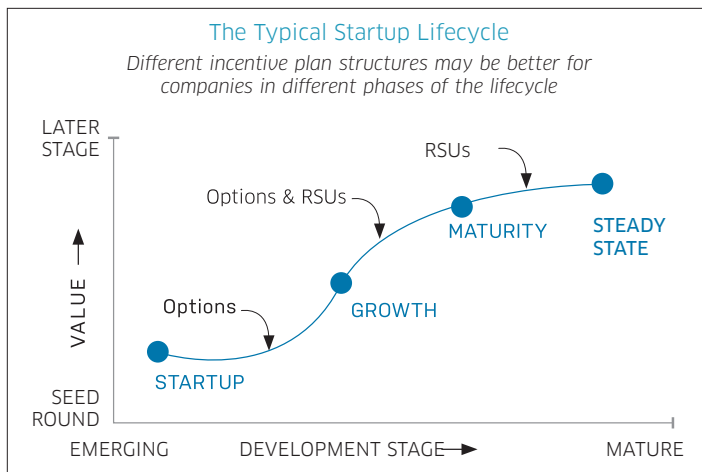
# Nasdaq Private Market:

## An Overview of Restricted Stock Units for Private Companies

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## NASDAQ PRIVATE MARKET WHITEPAPER ON RESTRICTED STOCK UNITS

As private companies continue to evolve and rapidly grow in size, retaining and attracting top talent has become increasingly challenging.<sup>1</sup> There are many ways to structure an employee equity program, but the vast majority of private companies choose stock options (options) or restricted stock units (RSUs). At Nasdaq Private Market, we have facilitated over 200 secondary programs since 2013, and we primarily work with companies that allow employees to sell vested shares or exercise and sell options. While option grants still dominate the private company market, we have seen several companies exploring or implementing RSUs as an equity incentive for employees.<sup>2</sup> As a result, these companies want to know what solutions are available for addressing liquidity prior to an IPO or M&A event. This paper will cover a quick introduction to RSUs, the advantages and disadvantages of using RSUs compared to options, and key considerations from NPM's experience dealing with RSUs in liquidity programs.



### AN OVERVIEW OF OPTIONS AND RSUs

Stock options represent the right, but not the obligation, to buy a company's stock at a specific price (referred to as "strike price" or "exercise price") at some point in the future ("exercise date"). Options can potentially provide a great deal of upside if the value of the company continues to grow, and are very popular among many startups and venture-backed companies. The two key types of options are Incentive Stock Options (ISOs) and Non-Qualified Stock Options (NSOs). ISOs are generally the most popular for employees because of tax implications during vesting and sale of the newly acquired shares, while NSOs are used on a more limited basis. NSOs are taxed at ordinary income rates at the time of exercise and generally make for a less favorable tax payment for the option holder.<sup>3</sup> In either case, when the option is exercised, the holder becomes an official shareholder of company equity.<sup>1,2</sup>

RSUs are an offer by the company to provide a specific number of company shares (or the cash equivalent of those shares at the time of vesting) at some agreed-upon timeframe in the future. This vesting period is usually time-based (e.g., 4 years from grant date) or event-based (e.g., IPO), and the holder's receipt of the shares is conditioned on the occurrence of these triggers. Similar to how option holders become official company shareholders when they exercise their options, RSU holders become official company shareholders when the RSUs vest.<sup>3</sup>

The decision to use RSUs or options is very specific to each company's lifecycle, liquidity needs, and employee retention and recruitment plan. RSUs can be a valuable resource for more mature companies that are not forecasting early-stage startup growth, but are still on track to grow for the foreseeable future. While options may inherently be riskier, there is greater potential upside to the holder if a company is growing at a very rapid pace.<sup>1,2</sup> Executives that NPM has spoken to, have seen the employee incentive benefits in both asset types, and can work with outside counsel or NPM to consider all the relevant attributes when designing an incentive program.

### A DEMAND FOR LIQUIDITY

Over the last two years, Nasdaq Private Market has seen record transaction volumes for secondaries in private companies, with overall transaction volume in 2017 reaching \$3.2 billion and skyrocketing to \$10 billion in 2018 (at time of writing).<sup>4</sup> Nasdaq Private Market has often seen options eligible for immediate exercise and sale in a tender offer, while RSUs have only been eligible for sale in five of the 200+ programs that NPM has worked on from 2013 to 2018 YTD (roughly 2.5% of all programs). While transactions including RSUs are infrequent, they are happening. Due to the fact that private company secondary transactions are harder to plan for if RSUs are involved means that RSUs have not been seen as much in the incentive structures of companies that have partnered with NPM. Broad liquidity becomes a growing challenge when multiple forms of equity have been issued across employees – options, RSUs, etc., and the company must address concern of alienating employees from the liquidity program who have received RSUs. Offering liquidity exclusively to holders of options and common stock does not have to be the path forward, and companies have been able to offer liquidity to RSU holders as well, as long as companies prepare in advance. NPM partners with outside legal counsel for many secondary transactions and we often hear counsel say that they have not seen a client do a liquidity program with RSUs. Some experts in the space we had spoken

Table 1: Advantages and Disadvantages of RSUs and Options <sup>5,6,7,8,9,10</sup>

	RSUs	Options
Advantages	<ul style="list-style-type: none"> <li>• Have value as long as stock has value (better downside protection)</li> <li>• Typically do not need to establish 409a (save money on valuation)</li> <li>• Can accelerate rate of vesting period at any time to give stock to RSU holders</li> <li>• Minimize dilution (i.e., generally one share per RSU granted)</li> </ul>	<ul style="list-style-type: none"> <li>• No taxes as options vest</li> <li>+ NSO taxed on exercise date</li> <li>+ ISO taxed when underlying stock is sold</li> <li>*Both still subject to paying exercise price</li> <li>• Provides inherent optionality for employee</li> <li>• Greater gain and liquidity (i.e., generally three shares per option granted)</li> </ul>
Disadvantages	<ul style="list-style-type: none"> <li>• Pay taxes on RSUs as they vest, and pay at ordinary income level</li> <li>• Long-term capital gains tax applies only if stock held for 12+ months after conversion</li> </ul>	<ul style="list-style-type: none"> <li>• If strike price greater than the stock price, then the option is worth \$0</li> <li>• Reissuing stock options can be a labor intensive process</li> <li>• Must do 409a alongside the issuance of options to establish a strike price</li> </ul>

to prior to this article had been trying to assess whether or not any companies they advised had done any of these programs – and they were unable to recall such a transaction, unless the companies had structured a program in a different way or had another unique factor that they were unaware of. During our discussions with private companies and external legal counsel leading up to this paper, we found that most of the questions around private company RSUs really only began to pick up around 2009 or 2010 with some companies adopting these programs around that same time. A very small minority of private companies we have spoken to are picking up on RSUs today. It generally includes later stage companies with higher valuations that expect to IPO soon or who have massive cash reserves and can take care of the tax implications on behalf of their employees.

A driver for wanting to use RSUs is that more and more private companies are competing to retain and attract top talent from public companies like Google, Facebook, and Apple. The RSUs have different implications for employees [than options], and are sometimes preferred by more senior members who join teams during the growth stage and later stages of a venture-backed company.<sup>9</sup> However, some recruiters may find it difficult to compare the advantage and disadvantages of RSUs and options to prospective employees, because both have very different ways of delivering value to the employee. Comparing these two incentive methods is like comparing apples to options.

#### VESTING CONDITIONS AND LIQUIDITY FOR RSUs

As a leading service provider to private companies, Nasdaq Private Market has worked with clients on secondary liquidity transactions across a myriad of structures and asset types. One of the more complex aspects of RSUs are their liquidity conditions. While options have very straightforward vesting and exercise criteria, RSUs can vest on a service-based vesting schedule and/or an event-based vesting schedule.<sup>7,9</sup> Some private companies use RSUs that they have a double trigger, meaning that have a service-based and event-based component to their vesting schedule. Others may only have a service-based vesting schedule (e.g., three to four years of time worked at the company), and this is where the challenges begin.<sup>9</sup> If a company grants RSUs with service-based vesting schedules, they may run into problems with liquidity. For shares that have vested, the employee will have a taxable event when those shares vest, but may be unable to pay the required taxes because there is no market for selling those shares right away. As a way to circumvent this problem, some companies choose to pay the tax obligations on behalf of their employee – the most common way to handle these issues. Nasdaq Private Market has the ability to assist companies in the sale of private shares via tender offers, block sales, and auction-format transactions, and can also handle RSU transactions, allowing holders of RSUs to sell their taxable portion to a third-party purchaser (or the company itself) to satisfy the payment requirements, thus addressing the tax problem through a secondary transaction. Nasdaq Private Market

has also helped facilitate transactions in which the company waives the liquidity event condition for double-trigger RSUs by allowing for a one-time special event that causes RSUs that meet the time-based component of their vesting schedule to vest immediately and be sold in a secondary transaction. This allows employees selling RSUs to potentially cover the taxes associated with the newly vested shares and to allow for the employee to earn additional compensation from the sale of those shares in a tender offer or buyback. However, some of these secondary sales often do not meet the immediate timeline of the individual shareholder, and most companies are not able to take on the tax burden created by the RSU vesting.

Another way companies are trying to avoid the issues of vesting, prior to identifying adequate liquidity solutions, is to use a double-trigger and defer service-based vesting timeframes until a particular event has occurred (i.e., essentially switching from service-based to event-based vesting). For event-based vesting, there must be a fixed date or event written into the vesting schedule at the time of the award that determines when these shares vest to qualify under IRS Section 409A.<sup>9,10</sup> A change of control or an IPO would typically trigger event-based vesting. With IPOs often pushed back or difficult to forecast, there's no guarantee, under 409A, that an IPO would be considered concrete enough (in terms of setting an exact date for a vesting condition) because of its lack of specificity. To address this, companies often put a time-based limitation around the award to make the award date more concrete, and ultimately make the vesting condition more supportable.<sup>10</sup>

The rise in demand for liquidity has prompted many questions regarding solutions for unvested RSUs and the employees who hold them. The main vehicle for offering secondary liquidity in private companies, the tender offer, can provide liquidity to RSU holders in the event that the RSU vesting schedule is able to be accelerated or the RSU is scheduled to vest on the same day as the tender offer start date. Only in very limited cases can RSU vesting be accelerated per Section 409a. Additionally, the company must be working with the IRS to show in good faith that the change of control or IPO is an appropriate vesting date. If the secondary sale happens prior to that change of control or IPO, and the company essentially waives the IPO condition as the vesting date and allows RSUs to vest immediately, the company may no longer be in compliance with 409a regulations and could inflict negative tax consequences on the employee.<sup>8,10</sup> Advisors have provided opinions in the past that private companies are able to offer liquidity through this process one time, but it cannot happen again due to the IRS questioning whether or not the change of control or IPO was a satisfactory

vesting condition. Most companies who have been presented with this option do not opt to perform a liquidity event with this accelerated vesting. Liquidity programs for employees should mostly be considered when sufficient opportunity for liquidity is provided. If liquidity is only a one-time event, it may discourage new employees from accepting RSUs or joining the company knowing that another secondary liquidity program is not possible.

Most companies who are able to successfully implement liquidity programs and grant RSUs have large cash reserves and can facilitate liquidity programs internally. These companies generally issue single-trigger RSUs, as dual-trigger RSU's avoid the need to hold large cash reserves. This allows the company to have more control over the vesting schedules for employees while also providing the employees with avenues for tax payment relief and equity incentives in the company.<sup>9</sup> That being said, the majority of private companies do not fall into this category so the industry is hesitant to adopt a standard RSU program. There is some possibility for the company to de-risk by taking time out of the 4-year vesting schedule and making it a 2 year cycle, but if something happens in the interim, the company may lose the opportunity for liquidity if the stock value goes down. With the continued interest and questions that NPM has received regarding creating a public company style RSU program for private companies, there is no doubt that there will be some evolution in how the programs are structured.

### **LESSONS LEARNED FROM WORKING WITH PRIVATE COMPANY CLIENTS**

One would think that public companies are a logical place to look to for best practices on RSU programs. Public companies, however, do not face the same liquidity and tax challenges as private companies. The one lesson we can learn from public companies is that planning ahead is paramount to successfully implementing an RSU program. When private companies first started issuing RSUs, it became apparent that the early incentive structures may have been seriously flawed. Very few of the companies thought about post-IPO settlement, timing of all of their vesting schedules, and caps for employees to sell vested shares once public. The first private companies continued to grant RSUs with custom vesting and settlement dates tied to their hiring dates, and it meant that four to six years later they had situations where RSUs were vesting and settling on almost every day of the year. One could see how poor planning could affect a private company's stock on the precipice of an IPO. For example, a private company may provide a fixed settlement date of RSUs six months after an IPO, which would fit traditional public company practices. But due to poor

planning and illiquidity, many of the RSUs could vest during that timeframe and employees may have to sell the vested shares immediately upon the settlement date to pay the tax obligations associated with the vesting. In this hypothetical event, it could lead to a massive sell-off of the stock by the employees, bringing down the value of the shares immediately after an IPO. This theoretical example is exactly why private companies thinking about RSU structures need to work closely with their legal counsel to map out all implications of implementing these incentive structures.

With these examples to learn from, companies are getting smarter about designing ways to use RSUs effectively in the private company space. Some companies have come up with methods to slowly release the number of shares that can be sold at any one time by their employees, but the ideas are still nascent and whether or not they are effective will only be known further down the line. Coming up with solutions to these problems may lead private companies to an effective equity incentive program, and there is an opportunity to help companies structure and design a path to liquidity for every asset type in a thoughtful and useful way.

#### ***A BLENDED APPROACH MAY BE THE BEST APPROACH***

Very few private company incentive programs offer both RSUs and options. Generally, companies offer options, then switch over to RSUs all at once when they are closer to an IPO or move to mature stages of growth where cash reserves are much larger. That does not mean that private companies have to choose one method or the other. In fact, a blended approach

may work for different employees at different levels. Options can be incredibly valuable if the value of the company continues to rise. However, the high strike price for newer employees can be daunting when it comes time to pay. This is where a blended RSU plus option program may be more beneficial and attractive to employees just joining the company. It may be helpful to have a blended approach because it can bring in the best of both worlds, with RSUs providing a guaranteed incentive to stay at the company longer term, and options providing the flexibility for employees to plan their expenses and estate. Overall, executives who are bullish regarding their company's performance will see the value in sticking with options, but a well-planned RSU program can allow them to compete with more established companies for talent.

There is no doubt that talent acquisition teams at private companies are feeling the pressure to compete with more established businesses in their industry, and focusing on employee incentives is a great place to make large scale improvements. While RSU programs at private companies are still in their infancy, expect to see more and more companies explore the idea of adding this asset class to their incentive plan. New structures that focus on and solve the problem of taxes at vesting will be key in accessing liquidity for employees with RSUs. Rest assured that new structures and interesting developments in this space will occur over the coming years. Private company employee incentives and the accompanying need for liquidity within those asset classes may lead to a new gold standard in hiring and recruiting processes.

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