Introduction
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Today’s Lecture

• “Old School” Venture Finance
• Securities Regulation 101
• The Regulation of Blockchain (but mostly tokens)
My New Startup
My New Startup
My New Startup
My New Startup
My New Startup
My New Startup
My New Startup
My New Startup

airbnb
### Historical Venture Financing Instruments

#### EQUITY
- Investment provides no fixed claim in firm’s assets (residual claim on cash flows)
- However, preferred equity will mimic debt w/ fixed claims on assets (liquidation preference)
- Upon insolvency, claim is junior to creditors, senior to Common Stock

#### DEBT
- Investment provides fixed claim entitling lender to return of principal + interest
- Upon insolvency, claim is senior to equity claims
  - Security interest?
Historical Venture Financing Lifecycle

Valuation of Co.

Stage of Financing

1st

Start-Up

$$_{\text{Common Stock}}$$

$$_{\text{Series A Preferred Stock}}$$

New VC

$$_{\text{Series B Preferred Stock}}$$

Existing VCs

New VC

Start-Up

Bridge Debt?

3rd, 4th…

Each subsequent round will also be just sufficient to get the company to another milestone; will ideally be at a higher valuation

Founders

$$_{\text{Common Stock}}$$

Start-Up

$$_{\text{Series A Preferred Stock}}$$

$$_{\text{Series B Preferred Stock}}$$
Priced Rounds

Priced Venture Finance Rounds (*Series A Financing*)

- Generally used for scaling up as opposed to starting up;
- Series A financings generally begin when investment is $2M-$10M;
- Investors (VCs) typically acquire an ownership stake between 20% and 30%; and
- Significant governance changes:
  - New board members
  - Significant control rights and information rights
A Simple Pricing Example:

- Assume single founder owns all 8,000,000 shares of startup company; VC proposes to invest $2,000,000 at a $8,000,000 pre-money valuation:
  - Pre-money valuation = $8,000,000
  - New money = $2,000,000
  - Post-money valuation = $10,000,000

- Post-financing, VC expects 20% ownership stake:
  - $2,000,000 new money / $10,000,000 post-money valuation
Example (continued):

- To ensure VC holds 20% upon conversion of Preferred Stock, price per share is calculated:

  \[
  \text{“Pre-Money” Valuation of the Firm} \quad \frac{\$8M}{8M} = \$1.00/\text{share}
  \]

- Post-financing capitalization:

<table>
<thead>
<tr>
<th></th>
<th>Common</th>
<th>Series A (as converted)</th>
<th>Total</th>
<th>% FDS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder</td>
<td>8M</td>
<td>0</td>
<td>8M</td>
<td>80%</td>
</tr>
<tr>
<td>VC</td>
<td>0</td>
<td>2M</td>
<td>2M</td>
<td>20%</td>
</tr>
<tr>
<td>Total</td>
<td>8M</td>
<td>2M</td>
<td>10M</td>
<td>100%</td>
</tr>
</tbody>
</table>
A Note on Valuations

From *Venture Deals (Feld and Mendelson)*:

- Stage of the company
- Competition with other funding sources
- Experience of the entrepreneurs and leadership team
- Size and trendiness of the market
- The VC’s natural entry point
- Numbers, numbers, numbers
- Current economic climate
1) **Explosion of seed stage funds and structure of early stage investment**

- First financing has moved earlier in lifecycle
- Convertible securities – lightly negotiated docs, quick and multiple closings
- No board seats & limited investor rights (pushed to priced round)

2) **Incubators/Accelerators**

- Depending on who you ask → 100-200 programs in the US; hundreds globally
Today’s Venture Financing Lifecycle

**EQUITY**
- Investment provides no fixed claim in firm’s assets (residual claim on cash flows)
- However, preferred equity will mimic debt w/ fixed claims on assets (liquidation preference)
- Upon insolvency, claim is junior to creditors, senior to Common Stock

**DEBT**
- Investment provides fixed claim entitling lender to return of principal + interest
- Upon insolvency, claim is senior to equity claims
  - Security interest?

**CONVERTIBLES**
- Debt or equity?
- Converts to equity in a future “qualified” financing at a discount
- Investment may mimic debt w/ principal + interest
- No stockholder rights (only contractual)
Today’s Venture Financing Lifecycle

<table>
<thead>
<tr>
<th>Stage of Financing</th>
<th>Founders</th>
<th>Start-Up</th>
<th>Angels / Seed</th>
<th>Series A Preferred Stock</th>
<th>New VC</th>
<th>Existing VCs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st</td>
<td>$$$$$</td>
<td>Start-Up</td>
<td>$$$$$$</td>
<td>Convertible Security (CS)</td>
<td>$$$$</td>
<td>$$$$$$</td>
</tr>
<tr>
<td>2nd</td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>3rd</td>
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<tr>
<td>4th, 5th…</td>
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</table>
Convertible Rounds

Convertible Venture Finance Rounds (Angel, Pre-Seed, Seed)

- Generally used for starting and scaling up and usually first round of financing from third party investors;
- Goal is to build value until startup is positioned for a priced round;
- Investment will convert to equity (preferred stock) at a discount through either the discount rate or conversion cap;
- Typical structure varies between “classic” convertible note, KISS/SAFE, simplified form of preferred stock (e.g., START);
- Benefit is speed – no need to negotiate valuation, control rights; and
- Holders are not stockholders → no governance rights.
Time Travel

THE ROARING TWENTIES
The Roaring Twenties
Quiz Time!
WALL ST. IN PANIC AS STOCKS CRASH

ATTEMPT MADE TO KILL ITALY'S CROWN PRINCE

Hollywood Fire Destroys Films Worth Millions

Fear 52 Perished in Lake Michigan Ferry Is Missing

Consolidated Studios Are Swept by Fire That Killed 12; Master Pictures Burned Include Many New Talkies Productions.

ATTEMPT MADE ON LIFE--Consolidated Studios Are Swept by Fire That Killed 12; Master Pictures Burned Include Many New Talkies Productions.

Wreckage Picked Up Indicates Craft Went Down With All Aboard.

ATTEMPT MADE ON LIFE--Consolidated Studios Are Swept by Fire That Killed 12; Master Pictures Burned Include Many New Talkies Productions.

Black and Orange Wreckage Indicates Death of Eight Body of Lake Michigan Ferry Victim is Brought Ashore.

STOCKS CRASH IN RUSH TO SELL--BILLIONS LOST

High Duty Group Gave $700,000 to Coolidge Drive

High Duty Group Gave $700,000 to Coolidge Drive

Morgan, Mitchell Buying Stocks in Effort to Check Rush to Unload.
What goes up...

Source: Business Insider
The Securities Act of 1933
The Securities Act of 1933

“Truth in Securities” Law

1) “Require that investors receive financial and other significant information concerning securities being offered for public sale.”

2) “Prohibit deceit, misrepresentations, and other fraud in the sale of securities.”

Source: Securities Exchange Commission
The Securities Act of 1933

Penalties may include...

- Injunction and Trading Suspensions
- Officer and Director Bars
- Civil/Monetary Penalties (including disgorgement)
- Criminal Penalties
The Securities Act of 1933

Prohibits selling or offering to sell a security to *anyone* unless:

1) You file a registration statement; or
2) You can claim an exemption from this requirement.
Registration Statement

Who cares? Why not just file a registration statement?

1) Prospectus – “Selling” document that must be delivered to everyone who is offered or buys. Includes information about business operations, financial condition, results of operations, risk factors, and management. Must also include audited financial statements.

2) Additional information and exhibits that must be filed with the Securities and Exchange Commission

Source: Securities Exchange Commission
Registration Statement

Who cares? Why not just file a registration statement?

According to PricewaterhouseCoopers…

• Planning an IPO takes 12-18 months; executing an IPO takes 6-9 months
• 83% of CFOs surveyed estimated spending *more* than $1M on IPO
• 2/3 of CFOs surveyed estimated spending between $1M and $1.9M annually on the costs of being public
The Securities Act of 1933

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2) You can claim an **exemption** from this requirement.
The Securities Act of 1933
What is a Security?

SEC v. W.J. Howey Co.
The *Howey* Test

An “investment contract” is any contract of profit-making scheme whereby:

(1) a person **invests his/her money** in
(2) a **common enterprise** and
   • Horizontal Commonality Test – sharing or pooling of funds or other assets by several investors (and sharing in profits and risks of the enterprise)
(3) **expects to make a profit**
(4) **solely from the efforts of the promoter or a third party** who is responsible for the management
In order to cover construction, AHF sells shares in Lakeview to tenants.

Tenants purchase 20 shares of Lakeview stock in order to move into the housing.

Tenants could lease parking and use of facilities.

Shares are non-transferrable w/ no voting rights and must be sold back upon moving out (at the original price).

Construction costs are higher than anticipated and AHF raises monthly rent.

Tenants sue and allege AHF violated securities laws.
Moot Court

https://pollev.com/adamsterling224
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The Securities Act of 1933

Relevant federal offering exemptions

1) The “Private Offering” Exemption (Section 4(2) of the ‘33 Act) – “The sale of stock to promoters who take the initiative in founding or organizing the business would come within the exemption.”

2) Rule 506 – “Private Offering” Exemption – In general, allows you to sell securities in a private placement if…
   - Offer/sell only to people you know personally or who you know with 100% confidence have financial sophistication and can bear the risk of a start-up investment.
   - Sell only to “accredited investors”
     - Humans – Wealth Test OR Income Test
     - Entities – Asset Test & can’t be formed for the purposes of investing in offering

3) Rule 701 – Compensatory Equity Awards
Token Sales
Token Sales

Blockchain protocol tokens, or simply “tokens,” are digital assets used in connection with decentralized services, applications and communities (collectively, “token networks”).

Source: Cooley SAFT Project
Token Sales!

The public token sale, colloquially known as an “Initial Coin Offering,” is a powerful new tool for creating decentralized communities, kickstarting network effects, incentivizing participants, providing faster liquidity to investors, and forming capital for creators. In these sales, network creators sell an amount of the network’s tokens at a discount to users, investors, or both. Some token sales take place when or after the token network is launched, as a means to disseminate some fraction of the token supply to early users. Other token sales happen long before the token network has genuine functionality; so called “direct token pre-sales” are sold at greater discounts with the goal of financing the development of the network and its launch.

Source: Cooley SAFT Project
Moot “Crypto” Court

THE HAIRBNB FOUNDATION

- Adam Sterling and co-founder Jeff Bezos post a “whitepaper” on Facebook.
- Potential “hairheads” acquire the right to hairbnb tokens through a donation to the hairbnb foundation.
- We expect the hairbnb platform to be operational in early 2019. Once live, hairheads will be able to obtain tokens at a 20% discount. Proceeds from the “donation drive” will be used to build the platform.
- 100 hairheads acquire the right to the hairbnb tokens and all are accredited investors.
- Hairheads are able to exchange/sell/trade the tokens.
Moot “Crypto” Court

https://pollev.com/adamsterling224
The DAO Token

Decentralized Autonomous Organization (DAO) – Smart Contract on the Ethereum platform

- Users purchase DAO Tokens
- In exchange for ether
- Ether would be pooled
- DAO Token holders would vote on a menu of investments
- DAO Token holders would share in profits pro rata to their investment

Securities and Exchange Commission → DAO Token is a security
Other Issues

- The Simple Agreement for Future Tokens (SAFT)
- Other U.S. Laws/Regulations
  - Money Transmitting Business (US Department of Treasury - Financial Crimes Enforcement Network “FinCEN”)
  - Federal Tax Laws
  - State Laws
  - Commodities/futures (Commodity Futures Trading Commission “CFTC”)
  - Fraud
  - Regulation of exchanges
  - Public company issues
- International Regulation