

Finance, Securities, Regulation

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Introduction



Introduction

Ucla



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BerkeleyLaw
UNIVERSITY OF CALIFORNIA

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Introduction



G U N D E R S O N D E T T M E R



Introduction



Berkeley Center for
Law and Business



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

hairbnb



Historical Venture Financing Instruments

EQUITY

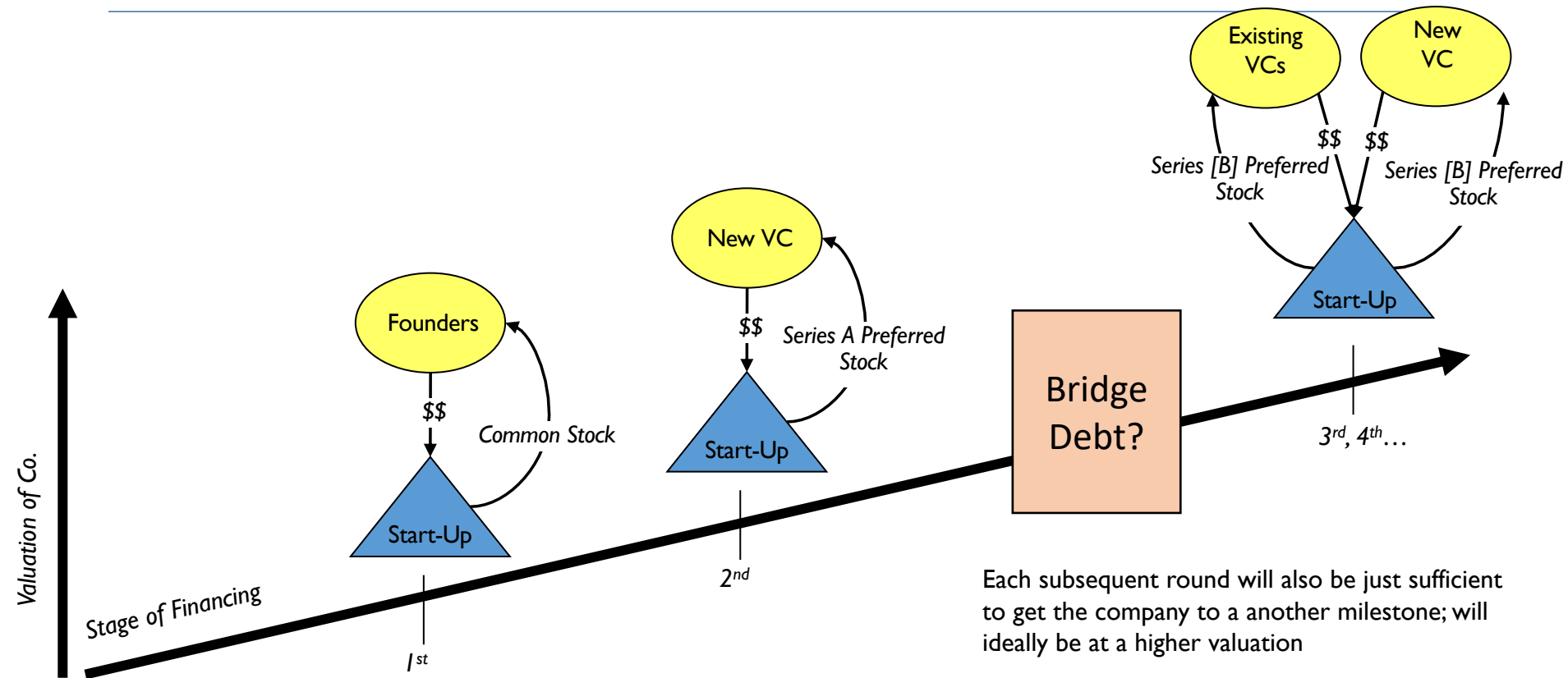
- Investment provides no fixed claim in firm's assets (residual claim on cash flows)
- However, preferred equity will mimic debt w/ fixed claims on assets (liquidation preference)
 - Upon insolvency, claim is junior to creditors, senior to Common Stock

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



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



Priced Rounds

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



Priced Rounds

Example (continued):

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

$$\frac{\text{"Pre-Money" Valuation of the Firm}}{\text{"Pre-Money" Fully-Diluted Capitalization}} = \frac{\$8\text{M}}{8\text{M}} = \$1.00/\text{share}$$

- Post-financing capitalization:

	Common	Series A (as converted)	Total	% FDS
Founder	8M	0	8M	80%
VC	0	2M	2M	20%
Total	8M	2M	10M	100%



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



What's Changed?

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

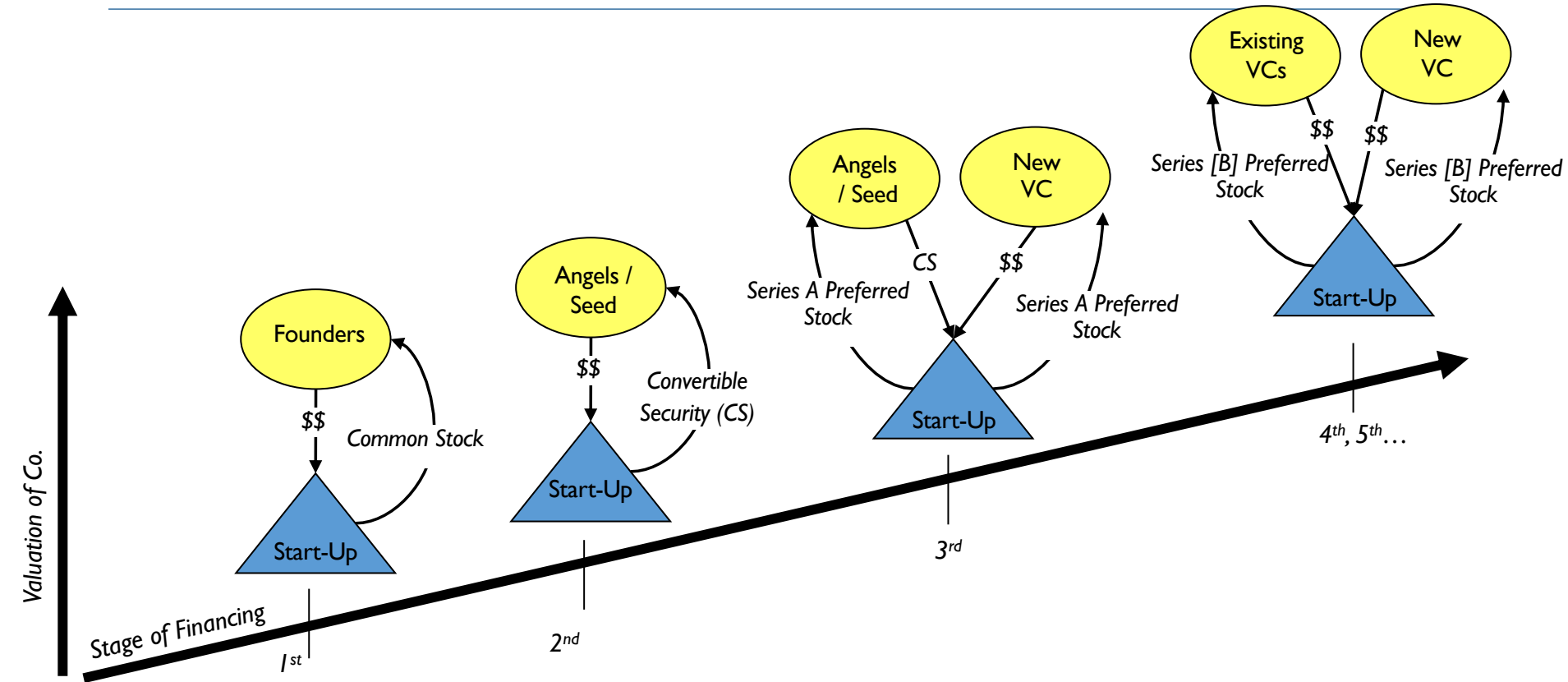
- Investment provides fixed claim entitling lender to return of principal + interest
- Upon insolvency, claim is senior to equity claims
 - Security interest?

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



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

GET IN TODAY

Burk-Waggoner Territory. A Chance for You to Get in Right in an Investment, not a Scheme

Burk-Waggoner paid \$3,333.33 on each \$100 Invested. DID YOU GET IN?

Horseshoe-Western Oil Co. Expected to be Equally as Good--Read the Facts--Then Get in Quick

Our Leases are: 30 acres in block 67 and 40 acres in block 8 Tillman County, Okla., about one mile south of Grandfield.

Our 30 acres in block 67 is on exactly same formation and dome as Burk-Waggoner. Our lease only a little over two miles from this well, closer to M & P Burk Well. Our lease is on the same dome following the bend in Red river on which Burk-Waggoner, United, Thrift and M & P Burks wells are. We are within a half mile of the Gold Leaf well, now preparing to bring in a well. When it comes in, you won't have a chance to get Horseshoe Western Stock.

OUR GUARANTEES

We guarantee to drill one well 2,000 feet deep if necessary and unless oil and gas is found in paying quantities at a lesser depth. We guarantee to pay 75 per cent of

earnings in monthly dividends. We guarantee to render stockholders MONTHLY statements each month after we get a well. We guarantee you a square deal and that you will get every dollar your investment earns.

HERE ARE THE MEN:

Jas. R. Robinson, President. Mr. Robinson is also president of Victor Refining Co., B. L. Fain, Oil Operator and Broker, N. M. Clifford, Treasurer; Assistant Cashier City National Bank, O. N. Hayes, Secretary; owner and manager Hayes Advertising Agency, Lamar D. Fain, member firm W. B. McCurran Co., one of largest dry goods firms in Wichita, Earnest R. Fain, Trustee, member same firm.

EVERY MAN IN THE COMPANY LIVES IN WICHITA FALLS AND WILL CONTINUE TO LIVE HERE AFTER THE COMPANY IS DEVELOPED.

Shares \$10 par value fully paid---Non-assessable CAPITAL \$130,000 THE PICK COMPANY OF THE FIELD

Horseshoe-Western

OIL COMPANY

714 Ohio St. Wichita Falls, Tex.

A Common Law Company
Live Agents Wanted

(Mail This Coupon Today if You Want in)
Horseshoe Western Oil Co.
714 Ohio Ave., Basement Central Stock Exchange,
Wichita Falls, Texas.

Gentlemen:--I want..... shares of your stock and
enclose \$..... in full payment at \$10.00 per share.
Name.....
Address.....Town.....(CCC)

If You Want in a Good Company, Get in Now.

There are any number of wells drilling, or preparing to drill near us. Dodson-Taylor, Gold-Burk, Henry Ford, Gold Point, Gold Leaf now down in sand, and scores of others.

We want you to look over all the companies and see if any of them offer you the square deal we do. Consider the amount of a choice acreage (not wildcat), the location, the capital stock of the men behind the company. If you will do this and be fair to yourself, you won't wait three hours to order your stock. WE WARN YOU RIGHT NOW--that if you have any idea of thinking this over for a week or so, you had just as well forget it now, because we expect to be sold out and drilling by that time.

IF YOU WANT IN A GOOD COMPANY--GET IN NOW.

J.S. BLAIN'S Greatest Land Offering

Greater than Merritt's Island Greater than St. Andrews Bay

\$15 per acre

37.50 BALANCE

10 Acres for \$150

Never before have you been offered such an opportunity--perhaps never again! A bargain feast for a few days

10 Acres for \$150

ALL-FLORIDA REALTY CO.
Distribution Office
Fort, Florida
Phone 1-100-1000

MAIL YOUR CHECK
\$37.50



Quiz Time!



What goes up...

Fair, slightly cooler tonight.
Friday fair. Fresh south-
west to west winds.
Temperature 57° at daylight. Barometer 30.1
Year ago (partly cleared) 34
Month average 45 years, same date 34

BROOKLYN DAILY EAGLE

And Complete Long Island News

LATE NEWS
WALL STREET
1:15 PRICES ★★

89th YEAR—No. 295.
★ NEW YORK CITY, THURSDAY, OCTOBER 24, 1929. ★
REISSUE 32 PAGES THREE CENTS

WALL ST. IN PANIC AS STOCKS CRASH

Attempt Made to Kill Italy's Crown Prince

ASSASSIN CAUGHT IN BRUSSELS MOB; PRINCE UNHURT

Royal Suitor Was About
to Lay Wreath on Un-
known Soldiers' Tomb.

Hollywood Fire Destroys Films Worth Millions

ATTEMPT MADE ON LIFE

FEAR 52 PERISHED IN LAKE MICHIGAN; FERRY IS MISSING

PIECE OF PLANE LIKE DITEMAN'S IS FOUND AT SEA

High Duty Group Gave \$700,000 to Coolidge Drive

STOCKS CRASH IN RUSH TO SELL; BILLIONS LOST

Consolidated Studios Are
Swept by Flames Fatal
to One—Master Pictures
Burned Include Many
New Talkie Productions.

Wreckage Picked Up In-
dicates Craft Went
Down With All Aboard.

Black and Orange Wreck-
age Indicates Daring
Flier Went to Death.

Grundy Agrees Rates Went
Up Due to His Activ-
ities as Propagandist.
Favors More Lobbying to
'Carry Out Voters' Wish.'

FOR MORE LOBBYISTS

Princess, Deeply Moved,
Falls Into Fiance's
Arms and Kisses Him

Brussels, Oct. 24 (AP)—Crown
Prince Humbert, after his re-

Hollywood, Oct. 24 (AP)—One man
was killed and motion picture films
the value of which probably will run
into millions of dollars, were lost
in an explosion and fire which de-

Milwaukee, Wis., Oct. 24 (AP)—
Hope that the car ferry Milwaukee
of the Grand Trunk fleet, with 52
aboard, had weathered the 48-hour
storm on Lake Michigan faded to-
day with a report that wreckage
from a boat had been picked up 10
miles off Wind Point, which is
about 4 miles north of Sheboygan.

St. John's, N. F., Oct. 24 (by the
Canadian Press)—The report from
Harbor Grace that the S.S. Kyle
had picked up a message from an
unidentified ship concerning the
finding of airplane wreckage was
stated by the Newfoundland man-
agement to be without foundation.

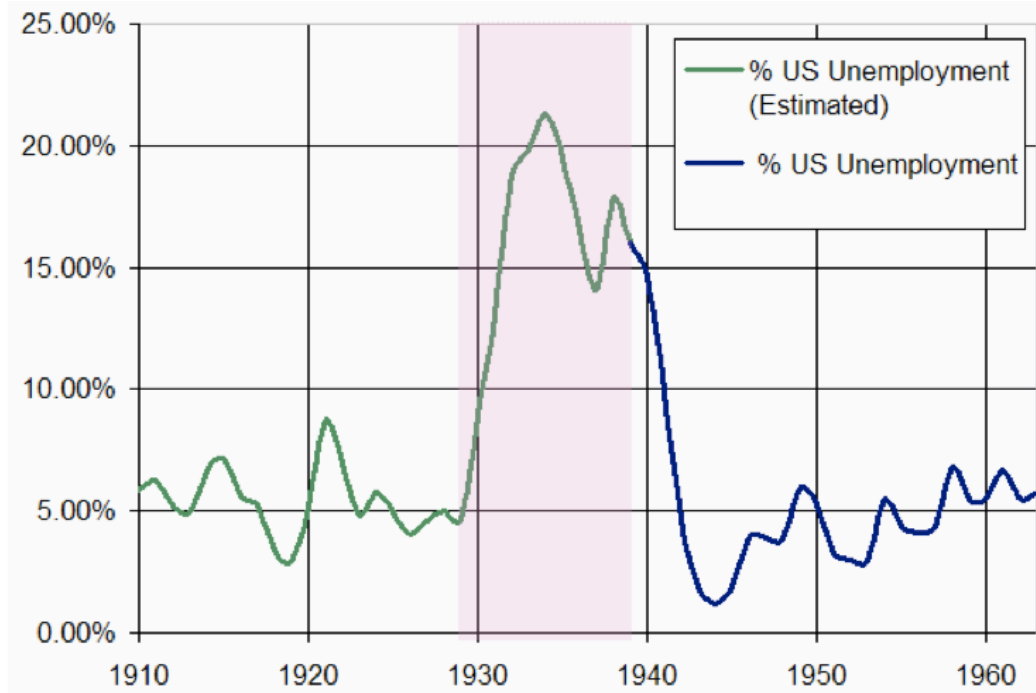
Eagle Bureau,
Capital Bid-
By HENRY SUYDAM.
Washington, Oct. 24—Jo-

Wall Street was in a
panic today, with no one
to guide it out. Stocks
crashed 10 to 50 points
to outrageous levels.
Wheat broke 10 cents a
bushel in Chicago on dis-
tress selling. Bankers
were offering some sup-
port, but admitted the
situation had gotten be-
yond them.
Charles E. Mitchell

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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The Securities Act of 1933

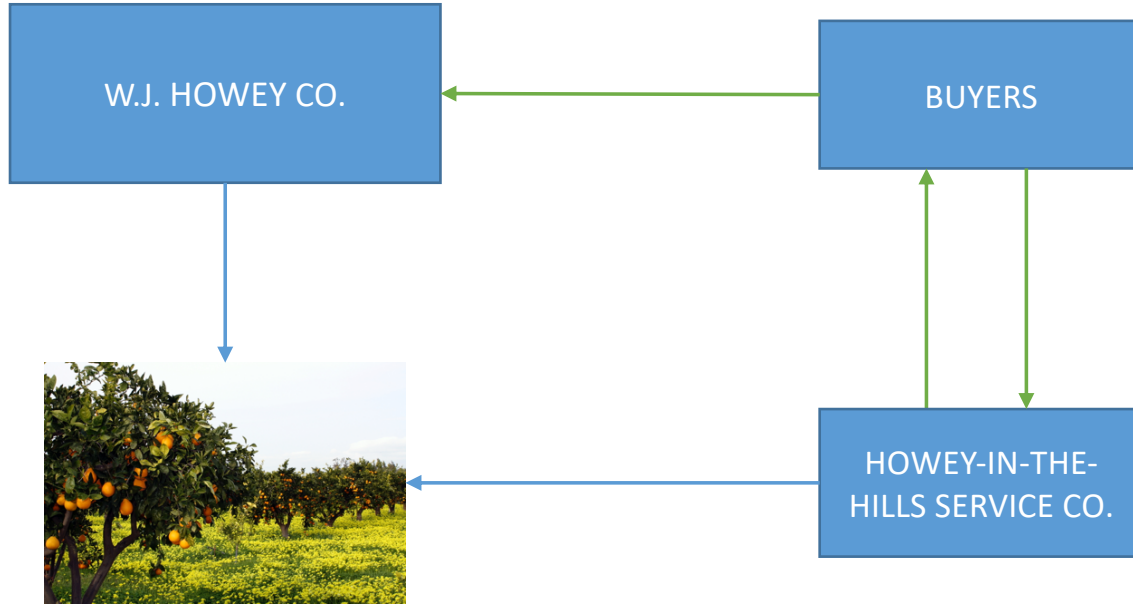


What is a Security?

Securities and Exchange Commission v. W.J. Howey Co., 328 U.S. 293 (1946)



SEC v. W.J. Howey Co.



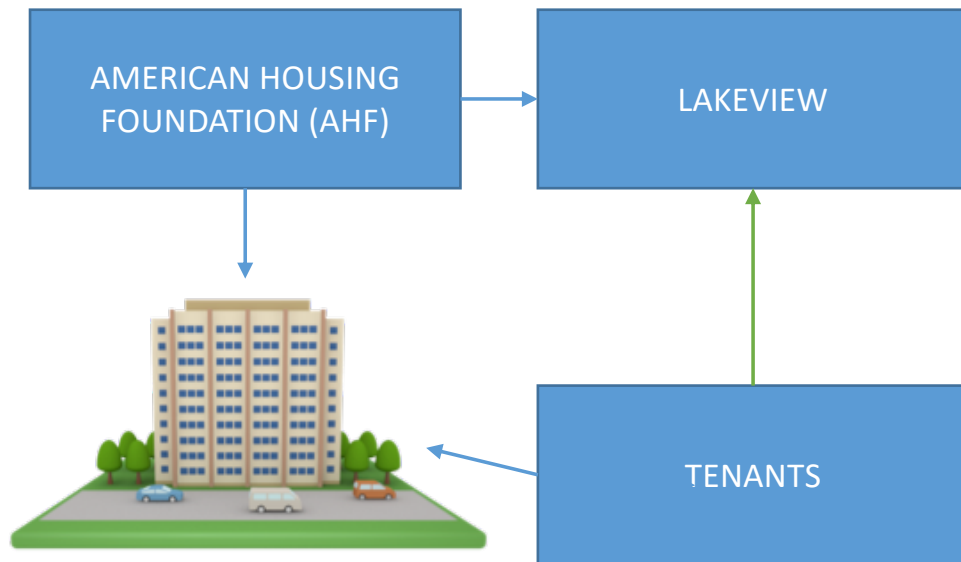
The *Howey* Test

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



Moot Court



- 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>



The Securities Act of 1933

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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.



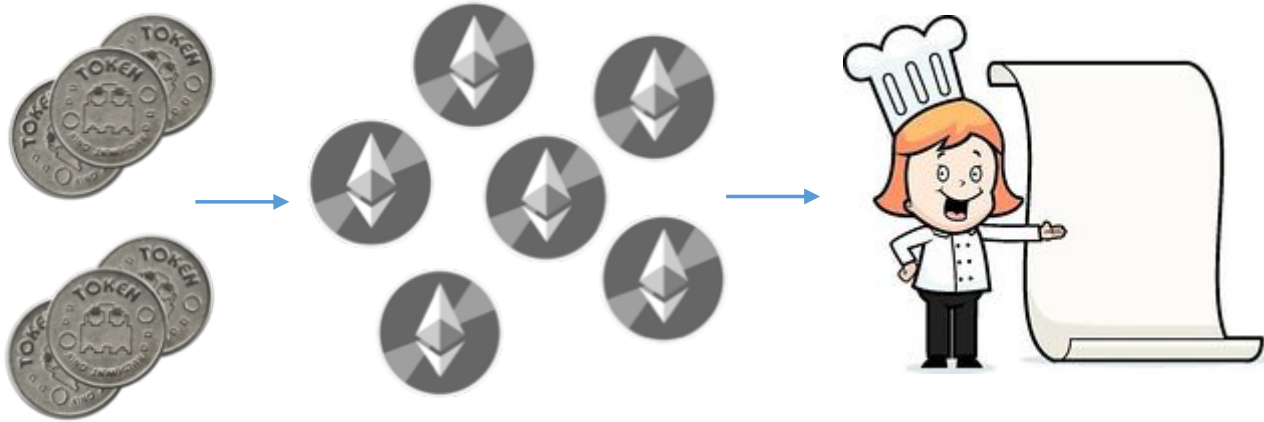
Moot “Crypto” Court

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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

