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FinTech University: Private Offerings of Securities

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Agenda

Introduction

When are Digital Asset Securities?

Are All Digital Assets the Same?

How to Structure a Private Placement of Digital Asset Securities?

How is VC Fundraising for web3 Different?

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What are Digital Asset Securities?

- The definitions of "**security**" under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act") are ***nearly identical,*** and each is ***broad enough to include the various types of instruments*** that are used in commercial marketplaces that one might suspect to fall within the ordinary concepts of a security.
- This would include common instruments like stocks, bonds, and notes, as well as the various collective investment pools and common enterprises devised by persons seeking to generate profits from the efforts and investments of others (i.e. investment contracts and instruments commonly known as securities).
- Section 2(a)(1) of the Securities Act defines a "**security**" as:

  [A]any ***note***, stock, treasury stock, security future, security-based swap, bond, debenture, ***evidence of indebtedness***, . . . transferable share, ***investment contract***, . . . any put, call, straddle, option, or privilege on any security, certificate of deposit, . . . or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

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What are Digital Asset Securities?

- **Investment Contracts (*Howey*)**
  - An ***investment contract exists*** when there is (i) an ***investment of money***, (ii) in a ***common enterprise***, (iii) with a ***reasonable expectation of profits***, (iv) derived from the entrepreneurial or managerial ***efforts of others*** in analyzing whether something is a security, ***"form should be disregarded for substance,"*** "and the emphasis should be on economic realities underlying a transaction, and not on the name appended thereto."
- **Note/Evidence of Indebtedness (*Reves*)**
  - "Notes" are specifically included in the statutory definition of a security, but not every "note" is a security.
  - Courts carved out exemptions and the U.S. Supreme Court in *Reves v. Ernst & Young* adopted the "family resemblance" test to determine whether a note is a security.
  - Notes that fall ***outside the definition of a "security"***: (i) a note delivered in a ***consumer financing***; (ii) a note ***secured by a mortgage on a home***; (iii) a ***short-term note secured by a lien*** on a small business or some of its assets; (iv) a note ***evidencing a character loan to a bank customer***; (v) a ***short-term note secured by an assignment*** of accounts receivable; (vi) a note that ***formalizes an open-account debt*** incurred ***in the ordinary course of business***; and (vii) a note evidencing ***loans by commercial banks*** for current operations.

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What are Digital Asset Securities?

- In *Marine Bank v. Weaver,* the U.S. Supreme Court noted that while ***the definition of "security" in the Exchange Act is quite broad***, Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud.
- The Court cautioned, however, "[t]he definition of 'security' in the [Exchange] Act provides that an instrument which seems to fall within the broad sweep of the [Exchange] Act is not to be considered a security if the context otherwise requires."
- For purposes of this presentation, we use the term ***"digital asset"*** in the same manner as the SEC to refer to ***"an asset that is issued and transferred using distributed ledger or blockchain technology."*** *See* Statement on Digital Asset Securities Issuance and Trading, Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets, SEC (Nov. 16, 2018).
- As the SEC has noted, digital assets ***include, but are not limited to virtual currencies, coins, and tokens***.
- A digital asset ***may*** in certain instances be deemed a security under the federal securities laws – ***it doesn't matter what you call it***
- While not defined in the securities laws, the SEC often refers to digital assets that are securities as a "digital asset securities."

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Are All Digital Assets the Same?

- **Tokens**
  - Technically, "token" is just another word for "cryptocurrency" or "cryptoasset."
  - ***Tokens have a huge range of potential functions***, from helping make decentralized exchanges possible to selling rare items in video games. But they can all be traded or held like any other cryptocurrency.
- **Coins**
  - Currency or exchange tokens are the most recognizable crypto assets, like Bitcoin and Ethereum, ***used as a means of payment.***
- **Non-Fungible Tokens (NFTs)**
  - NFTs are created as part of a platform built on an existing blockchain and ***are not fungible*** like other cryptocurrencies meaning NFTs cannot be traded or exchanged for one another without inherent diminution in value.
  - NFTs are created from digital objects that represent tangible and intangible property, including: (i) artwork, (ii) videos, (iii) collectibles and antiques, (iv) video game avatars, and (v) music.

Bored Ape Yacht Club

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Are All Digital Assets the Same?

- **Does it Matter?**
  - A different set of regulations and agencies will apply differently to alternate definitions of digital assets.
  - Generally, most definitions to date distinguish between four types of crypto assets:
    - Digital currency used as a means of payment
    - utility or consumer tokens represent use of or access to a blockchain-based application or service
      - For example, users of Siacoins can use the tokens on a blockchain network solely to purchase and sell storage space
    - asset-backed tokens pegged to real-world units of value
    - NFTs
  - ***It does not matter what you call it, if the SEC deems it is a security.***

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Private Placements

- The SEC has defined private placements as a ***securities offering exempt from registration*** with the SEC, under federal securities laws securities offerings must be registered – unless they are subject to an exemption or safe harbor.
- Under Section 12 of the Exchange Act an ***issuer may inadvertently become a reporting company*** if it has more than $10 million in total assets and a single class of securities held by (1) 2,000 or more shareholders or (2) 500 or more persons who are not accredited investors.
  - This can be a challenge of digital asset securities issuers who want to reach retail investors.
- Private Placements can be structured under numerous safe harbors or exemptions:
  - <u>Regulation CF</u>
    - Cap of $5 million in any 12-month period;
    - Any investor, accredited or not, can invest; and
    - This can crowd the cap table and make the Company less attractive to future VC investors.

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Regulation A

- Requires the filing of a Form 1A with the SEC.
- Reg A offerings can be made to retail investors (non-accredited) in the US.
- Two possible bases for exemption for Reg A, an exemption to registration under the Securities Act:
  - Tier 1: Cap of $20 million in any 12-month period, US or Canadian issuer;
  - Tier 2: Cap of $75 million in any 12-month period, US or Canadian issuer, limits the amount of securities that an investor who is not an accredited investor can purchase.

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Regulation S

- Two non-exclusive safe harbors to conduct offshore transactions:
  - Rule 903: Issuer safe harbor
  - Rule 904: Resale safe harbor
- Two conditions:
  - The offer and sale of the securities must be made in an "offshore transaction"; and
  - ***There can be no "directed selling efforts" in or into the US of the securities offered under Regulation S.***
- Also, issuer must avoid backflow of digital asset securities into the US (restrictions on resales to US investors) so they need to geofence.

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Regulation D

- Three possible bases for exemption for Reg D:
  - **Rule 504**
    - Cap of $10 million in any 12-month period
    - Issuers can be any company that is not a reporting company, investment company or blank check company
  - **Rule 506(b)**
    - No cap
    - Any company can be an issuer
    - ***Cannot use general solicitation***
    - Securities may be sold to an unlimited number of ***"accredited investors"*** and up to ***35 "other" investors*** that are considered sophisticated
  - **Rule 506(c)**
    - No cap
    - Any company can be an issuer, but ***needs to conduct accredited investor qualification***
    - ***Can use general solicitation***
    - May be sold only to ***"accredited investors"***

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Private Placements

Practical Law™

View the online version at http://us.practicallaw.com/8-563-3625

Comparative Chart: Regulation D, Amended Regulation A and Regulation Crowdfunding

PRACTICAL LAW CORPORATE & SECURITIES

	Rule 504 of Regulation D	Rule 506(b) of Regulation D	Rule 506(c) of Regulation D	Regulation A, Tier 1	Regulation A, Tier 2 (Reg A+)	Regulation Crowdfunding
Cap on the amount that can be raised?	$10 million per 12-month period.	No cap.	No cap.	$20 million per 12-month period. (An issuer raising less than $20 million may opt for Tier 1 or Tier 2.)	$75 million per 12-month period. (An issuer raising less than $20 million may opt for Tier 1 or Tier 2.)	$5 million per 12-month period.
Eligible issuers?	Any company that is not a reporting company, an investment company or a blank check company.	Any company, including reporting companies and non-reporting companies.	Any company, including reporting companies and non-reporting companies.	Any US or Canadian issuer that is not: an investment company, a blank check company, a business development company, an issuer of fractional undivided interests in oil or gas rights, an issuer required to file but delinquent in filing ongoing reports under Regulation A, an issuer that had its registration revoked under Exchange Act Section 12(j), or a "bad actor" (see below).	Any US or Canadian issuer that is not: an investment company, a blank check company, a business development company, an issuer of fractional undivided interests in oil or gas rights, an issuer required to file but delinquent in filing ongoing reports under Regulation A, an issuer that had its registration revoked under Exchange Act Section 12(j), or a "bad actor" (see below).	Any US issuer that is not: a reporting company; an investment company (or excluded from the definition of investment company under Investment Company Act Sections 3(b) and (c)); a company with no business plan or a business plan to merge with an unidentified company or companies; or an issuer that has failed to make any required Form C filing in the past two years.
"Bad actor" disqualification?	Yes.	Yes.	Yes.	Yes.	Yes.	Yes.
Can existing securityholders sell in the offering?	No.	No.	No.	Yes. In an issuer's first Regulation A offering and any offering during the next 12 months, sales by selling securityholders are limited to no more than 30% of the aggregate offering price of any offering. After the one-year anniversary of an issuer's first Regulation A offering, the 30% cap described above continues to apply to sales by affiliate securityholders but does not apply to sales by non-affiliates.	Yes. In an issuer's first Regulation A offering and any offering during the next 12 months, sales by selling securityholders are limited to no more than 30% of the aggregate offering price of any offering. After the one-year anniversary of an issuer's first Regulation A offering, the 30% cap described above continues to apply to sales by affiliate securityholders but does not apply to sales by non-affiliates.	No.

Note: This chart offers only a high-level summary. For more in-depth analyses, see the resources listed at the end of this document.

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  - Tax

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