CRYPTO ECONOMY WORLD 2018

MASTER SESSION - RAISING UNLIMITED INVESTOR CAPITAL IN THE USA WITH REG D

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Barcelona – October 16, 2018
WHY GIVE THIS PRESENTATION TODAY?

ICO NEWS OCTOBER 11, 2018 07:45 CET

U.S. SEC Gets Tougher with Crackdown on ICO Funded Startups

"The U.S. Securities and Exchange Commission (SEC) has intensified efforts to crack down on Initial Coin Offering (ICO) funded startups.

The financial regulator who had sent out a number of subpoenas to startups that failed to comply with its rules at the beginning of the year seems to be exerting more pressure on those startups to settle their cases, according to a report from Yahoo Finance.

For the companies, while some have been able to get off the SEC's hook by quietly refunding investors money and paying a fine, others argue that they have been left in the dark regarding what the agency wants or how to satisfy its demands, according to anonymous sources who spoke on a recent investigation into the matter. Yahoo Finance and Decrypt conducted an investigation, where they spoke with industry sources, many of whom are employees of companies that have been subpoenaed by the SEC in the past."

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WHY GIVE THIS PRESENTATION TODAY?

Oct 15 · 13 min read

The Blockchain Party is Over

And vultures are circling to tokenize the world

"It's been a wild ride. The boat cruises. Lavish events. Lambo memes. Champagne on the beach. Conferences across Asia, Europe, Dubai, and the Caribbean. The abundant private VIP dinners and posh after parties sponsored by some hot new ICO. On and on and on.

Now the blockchain party is over.

It's time to build real products and deliver on the dream sold through white papers and barely functional MVPs. That means blockchain founders need to step up and execute — regardless of the value of tokens or their crypto portfolio. Blockchain isn't about enriching ourselves — it's about a revolution to co-create a better world."

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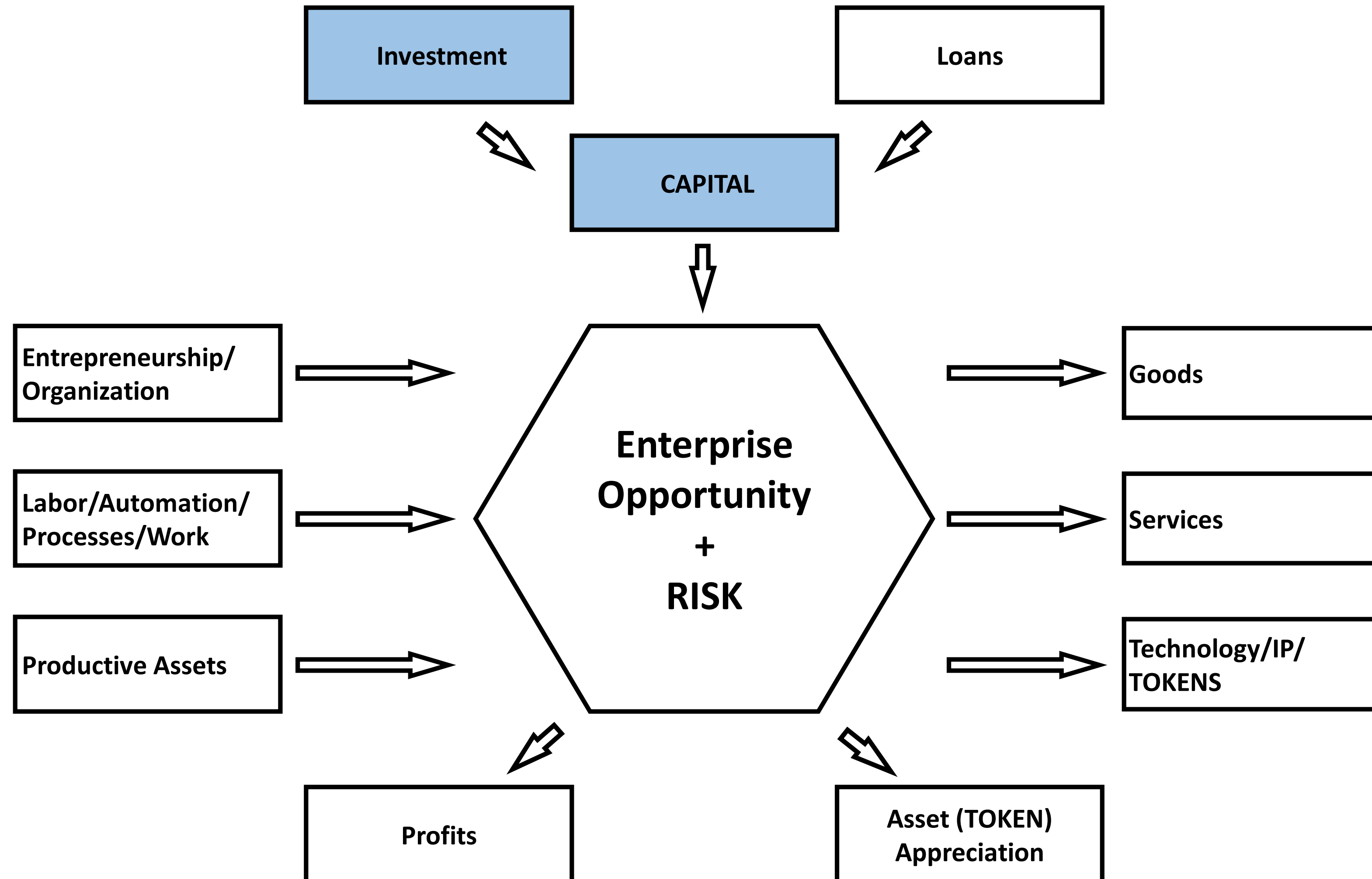
GAGING THE AUDIENCE

- Who was or is part of one or more crypto-/blockchain startup founding groups?
- Who was or is investing in one or more crypto-/blockchain startups?
- Who has raised investor capital globally?
- Who has raised investor capital in the US?
- Who is concerned about the SEC? ("concerned" does not equal "afraid")
- Who has heard about and/or used "Reg D"?
- Who.... ☺?

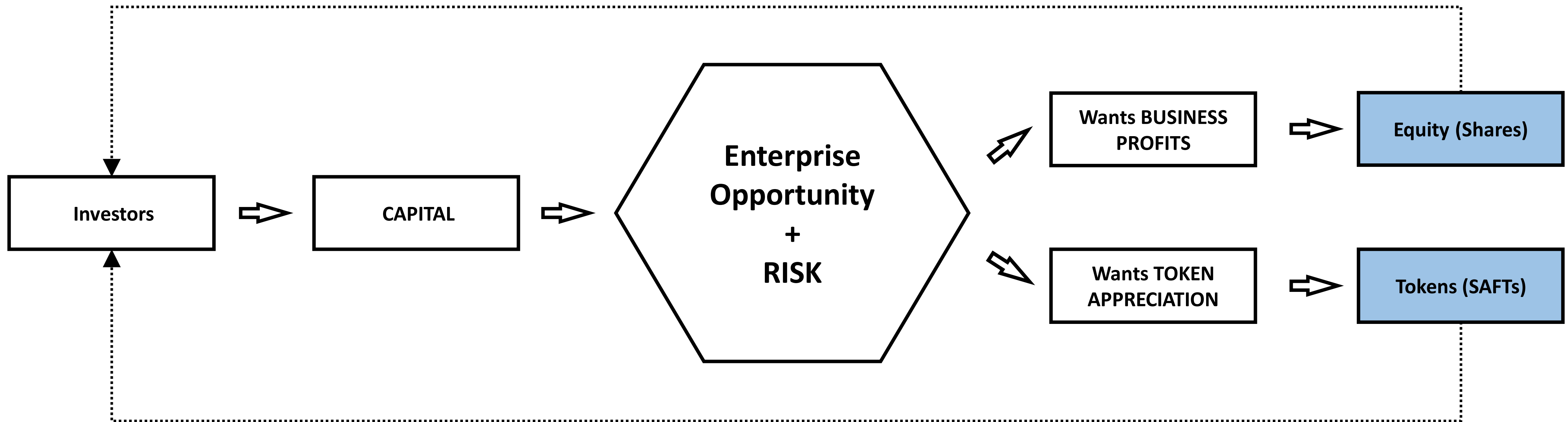
THE BOTTOM LINE DOs and DON'Ts.

- **DO** use "Reg D" Rule 506(c) to conduct a "private placement" of securities and raise unlimited capital from an unlimited number of "accredited investors".
- **DO** verify that these investors are actually accredited – **DON'T** take their word for it.
- **DON'T** mess around with "unaccredited investors".
- **DON'T** mess around with "bad actors".
- **DON'T** make any misrepresentations of material facts (or omit such facts) when offering or selling securities.

Why raise capital? To fund risky enterprise opportunities.



Modes of blockchain enterprise investment.



Shares of stock and SAFTS are both “securities” (as are many other instruments of investment).

“Securities” definition (the short version).

The legal interest which an investor receives in exchange for contributing capital (whether money or some other thing of value) to an enterprise in the hopes of realizing a profit or other economic benefit resulting from the enterprise’s success, but where such outcome is not guaranteed, and the invested capital is at risk of being reduced or lost.

Basically – an “investment contract”.

Securities regulation is complex and scary – especially in the US.

- Selling securities is highly regulated everywhere, especially in developed economies (exactly where the desired investment capital is located).

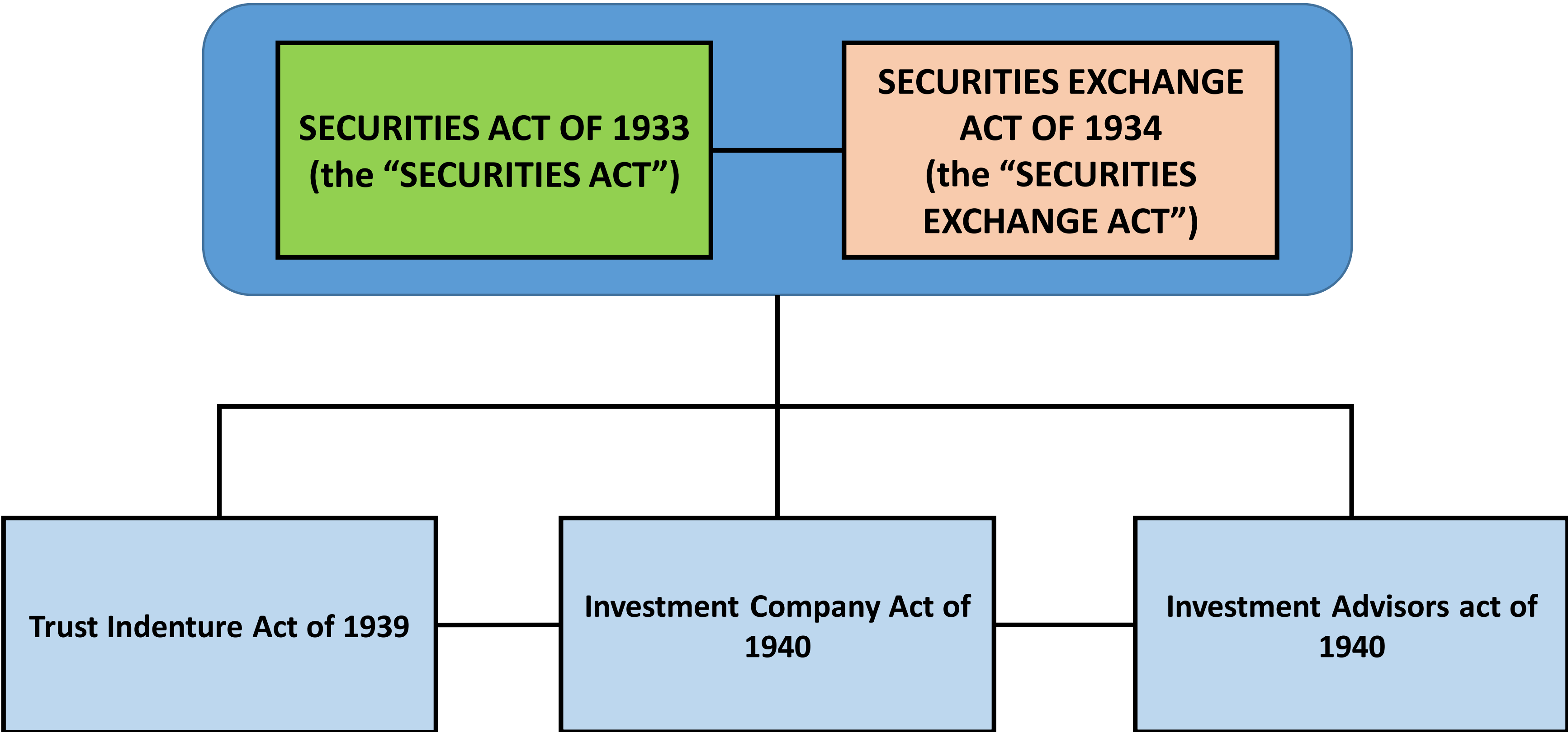
- US securities regulation has a reputation for being especially complex and punitive.

- The US Securities and Exchange Commission (the "**SEC**") has a reputation for being very aggressive in protecting US investors.

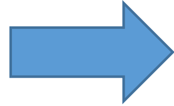
Why bother with US capital markets?

- The US is the largest national economy, and largest national capital market, on the planet (at least while China is offline).
- US investors want to invest in blockchain projects – and they do.
- Token sales are also marketing and PR events. Your competition will beat you if they access US capital markets and you don't.
- In reality US securities regulation is NOT bad – there are lots of helpful exceptions ("exemptions") to the default rules.

The FIVE foundational statutes of US securities regulation.



Saying "hello" to the Securities Act.



AN ACT To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I

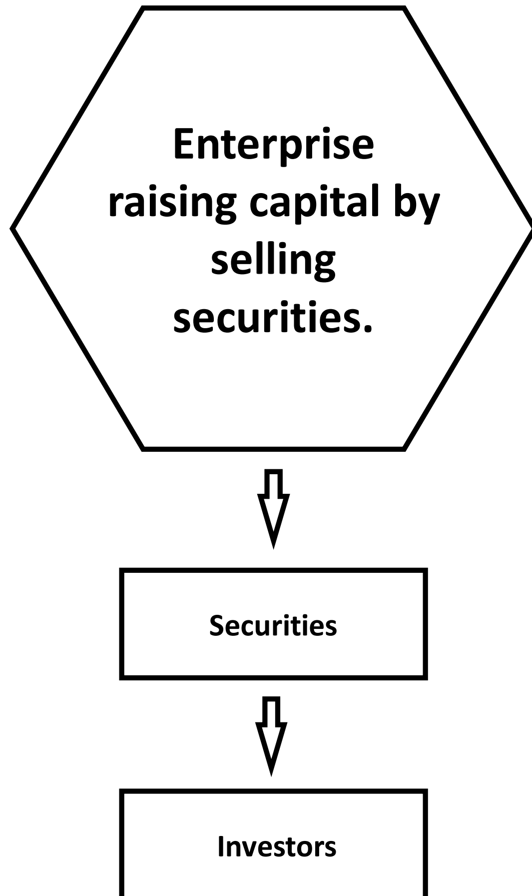
SHORT TITLE

SECTION 1. [77a] This title may be cited as the "Securities Act of 1933".

Purposes of the Securities Act:

1. To provide full disclosure of the character of securities being sold.
2. To prevent (and punish) fraud in the sale of securities.

The Securities Act's coverage.



First, some terminology.

The enterprise **SELLING** or **OFFERING** for sale its own **SECURITIES** to a US **PERSON** in order to raise capital is the **ISSUER**.

Such an issuer sale is referred to as a **DISTRIBUTION** of securities.

Note - when the same securities are later bought and sold on an **EXCHANGE** or **OVER THE COUNTER**, this is referred to as **TRADING**.

<u>The Securities Act covers INITIAL or PRIMARY DISTRIBUTIONS of securities.</u>

Despite some confusing wording, the Securities Act (with important exceptions) does **NOT** cover what happens later. In other words, it generally does not cover exchanges, investors selling stock to other investors, etc.

“Securities” definition (the long version).

SEC. 2. [77b] (a) DEFINITIONS.—When used in this title, unless the context otherwise requires—

(1) The term “security” means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), 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.

§5 – The Security Act's "default rule".

The Securities Act's "default rule" is that it is UNLAWFUL to sell, offer to sell, or deliver securities unless:

1. A **REGISTRATION STATEMENT** is in **EFFECT** with respect to such securities (which requires SEC approval); and

2. A **PROSPECTUS** has been provided which meets the requirements of §10 of the Securities Act (which also requires SEC approval).

Preparing, filing, amending and finally getting approval from the SEC for an issuer's registration statement and prospectus is very time-consuming and expensive. It is only appropriate for large companies looking to **GO PUBLIC** via an **INITIAL PUBLIC OFFERING** (an "**IPO**").

AND, any company which does this is now a **PUBLIC COMPANY**, meaning that it now also needs to stay in compliance with the Securities Exchange Act.

99.9% of the time this is NOT the desired situation.

§3 - "Exempted **Securities**".

EXEMPTED SECURITIES [3]

SEC. 3. [77c] (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

Some examples:

- §3(a)(2) – Any security issued by the US, any territory thereof, or any US State.
- §3(a)(4) – Any security issued by a non-profit where none of the non-profit's net earnings inure to the benefit of any private party.
- §3(a)(9) - Any security issued by the issuer to existing holders of that issuer's securities where no sales commission are paid.
- §3(a)(11) - Any security offered and sold entirely within a single US state.

§4 - "Exempted **Transactions**".

EXEMPTED TRANSACTIONS [15]

SEC. 4. [77d] (a) The provisions of section 5 shall not apply to—

(1) transactions by any person other than an issuer, underwriter, or dealer.

(2) transactions by an issuer not involving any public offering.

AWESOME!!!

Under §4(a)(2) an issuer can avoid the entire registration process required by §5 by not engaging in a **PUBLIC OFFERING**. In other words, by doing a **PRIVATE PLACEMENT** of the issued securities.

BUT – what does that mean exactly? Where is the dividing line between a public offering and a private placement?

§4(a)(2) – What makes an offering a "private placement" (not a "public offering")?

BEFORE Reg D (i.e., before 1982), some factors looked at by the courts (these are still influential):

- The offer is made to a relatively small number of sophisticated investors.
- No general solicitation or general advertising of the offering by the issuer (or its agents).
- The issuer provides either an offering memorandum, or there is sufficient public information about the issuer.
- The investors know the issuer or the issuer's business sector.
- The investors are given access to management before entering into a sale and may ask questions.
- The investors are looking to hold the securities for the long term and do not intend to quickly resell them to other investors.
- The degree to which the transaction is confidential.

Want certainty? Reg D to the rescue.

REGULATION D ("**REG D**") is a cluster of **RULES** (now 501-508), promulgated by the SEC starting in 1982, which provides some "bright line" **SAFE HARBORS** (plural) for certain securities transactions.

If an issuer complies with the rules in Reg D, then the issuer can be sure that the issuance of securities is <u>*exempted from registration*</u> under §5. Phew!

These Reg D safe harbors are based upon §3(b) (which we did not cover) and §4(a)(2) (which we DID cover).

Rule 506 relates to "private placements" under §4(a)(2). The Jumpstart Our Business Startups Act of 2012 (the "JOBS Act") resulted in a major SEC revision to Rule 506.

<u>**You want to use the (new) Rule 506(c)!**</u>

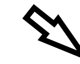
Reg D - Rules 501 – 503 & Rules 507 - 508

These rules apply to ALL Reg D offerings.

- **Rule 501** - definitions that apply to all of Reg D.
- **Rule 502** – conditions for using Reg D such as:
    1. All sales which occur within a certain period will be treated as “integrated”;
    2. Specifies what information and disclosures must be provided;
    3. There must be no "general solicitation“ (not always true!);
    4. That the securities being sold contain restrictions on their resale.
- **Rule 503** - requires issuers to file a Form D with the SEC when they make an offering under Regulation D.
- **Rule 507** - penalizes issuers who do not file the Form D.
- **Rule 508** - provides SEC enforcement guidelines related to Reg D issuers.

Rule 506, and its variants (part 1).

RULE 506 (GENERALLY)
Private placement under §4(a)(2). EXEMPTED from §5.
No limit on offering size.
No limit on number of accredited investors.
Must file “Form D” with the SEC.
“Bad actor” disqualification danger.
Resulting securities are “restricted”. And see “Rule 144”.
Management available to answer questions.



RULE 506(b)

RULE 506(c)

The “accredited investor”.

Idea is that such investors are in a position to engage in their own information discovery regarding an investment opportunity. This can lead to an “exempted transaction” under Rule 506(b) and (c).

ANY of the following parties.
Annual income of $200,000 (or $300,000 joint income), for the last two years with expectation of earning the same or higher income.
Net worth exceeding $1 million, either individually or jointly with spouse.
Investor is a general partner, executive officer, or director of the issuer.
Certain defined entities (e.g., private biz dev co. with assets exceeding $5 million).
Investor who can demonstrate sufficient professional knowledge of unregistered securities.
Registered brokers and investment advisors automatically qualify.
(others…).

Form D.

File a Form D with the SEC. This is the “Notice of Exempt Offering of Securities”. Key word is “NOTICE”. The SEC is not “approving” anything.

FORM D

Notice of Exempt Offering of Securities

U.S. Securities and Exchange Commission

Washington, DC 20549

(See instructions beginning on page 5)

OMB APPROVAL
OMB Number: 3235-0076
Expires: November 30, 2019
Estimated average burden hours per response: 4.00

Intentional misstatements or omissions of fact constitute federal criminal violations. See 18 U.S.C. 1001.

Item 1. Issuer's Identity

Name of Issuer

Jurisdiction of Incorporation/Organization

Previous Name(s) ☐ None

Entity Type (Select one)

- ☐ Corporation
- ☐ Limited Partnership
- ☐ Limited Liability Company
- ☐ General Partnership
- ☐ Business Trust
- ☐ Other (Specify)

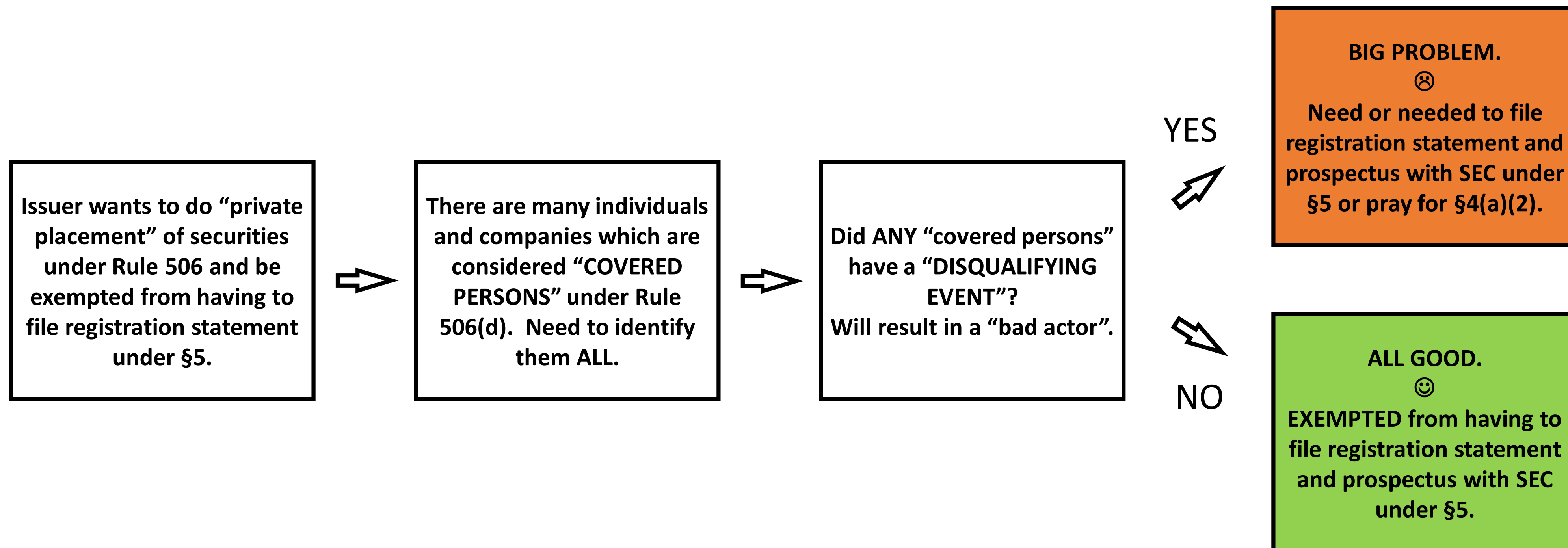
Year of Incorporation/Organization (Select one)

◯ Over Five Years Ago ◯ Within Last Five Years (specify year) ◯ Yet to Be Formed

(If more than one issuer is filing this notice, check this box ☐ and identify additional issuer(s) by attaching Items 1 and 2 Continuation Page(s).)

Rule 506(d) - The “bad actor” exemption destroyer.

Starting in 2013, Rule 506(d) denies use of Rule 506 exemption if a “covered person” has had a “disqualifying event”.



Rule 506(d) - The “bad actor” – “covered persons”.

“Covered person” are those parties who that have one of the enumerated relationships with the issuer (only). The “bad actor” concept does not apply to the purchaser, or purchaser-related parties.

“Covered persons”.
The issuer, including predecessors and affiliated issuers.
Directors, executive officers, other officers participating in the offering, general partners, managing members, etc. of the issuer.
Direct or beneficial owners of 20% or more of outstanding voting equity of the issuer.
Any promoters connected with issuer at the time of sale.
Any person or company compensated for soliciting investors. This includes the management of such a company.
(others…).

Rule 506(d) - The “bad actor” – “disqualifying event”.

“Disqualifying events” turn a “covered person” into a “bad actor”. No “bad actor” can be associated with a Reg D exemption, or else the exemption will be LOST.

“Disqualifying events” for “covered persons”.
The covered person has a conviction for a felony or misdemeanor, or an order or injunction, relating to: (i) the purchase or sale of a security, (ii) making a false filing with the SEC, (iii) etc.
If the covered person is regulated by the SEC (e.g., a broker), that person is subject to certain SEC orders.
The covered person is suspended or expelled from membership in a national securities exchange or securities association.
(others…).
Disqualifying events do NOT include anything that happens outside of the US!

Bottom line – do investigations, get representations, and add provisions to agreements.

Restricted stock and Rule 144.

- Recall that all public offerings of securities must be registered unless there is an exemption. This would generally apply to resales of “**restricted securities**” or “**control securities**” acquired directly from the issuer.
- “**Restricted Securities**” usually result from Reg D (Rule 506) sales and can be identified by the “**legend**” on the “**stock certificate**”.
- “**Control Securities**” usually are those held by an “**affiliate**” of the issuing company.
- **Rule 144** provides a non-exclusive “**safe harbor**” where non-public company stock may be resold after 1 year without registration.

Rule 506, and its variants (part 2).

RULE 506

RULE 506(b)	RULE 506(c)
Up to 35 unaccredited investors.	NO unaccredited investors.
Unlimited accredited investors.	Unlimited accredited investors.
Reasonable belief that investors accredited.	VERIFIED belief that investors accredited.
NO general solicitation or advertising - BAD.	General solicitation and advertising ALLOWED - GOOD. To EVERYONE.
Mandatory info to unaccredited investors (and then to others).	NO mandatory info disclosures.

Wait… What!?!?

§4(a)(2), on which Rule 506 is based, exempts non-public offerings. BUT, under Rule 506(c), you CAN engage in general (public) solicitation and CAN engage in general (public) advertising. POW.

Rule 506(c) - Verifying accredited investor status.

For Rule 506(c), cannot just take investor's representations at face value. Must conduct some investigation to VERIFY status.

Modes of "accredited investor" verification.
Investor questionnaire. Good enough for Rule 506(b). Not sufficient for Rule 506(c) (but good starting place).
Review of publically available information.
Reviews of IRS documents showing income over past 2 years.
Written representations from investor about expectations of future income.
Review of brokerage, investment and banking statements.
Representations from 3rd parties such as the investor's accountant.
Use of certain 3rd party verification services.
(and whatever else works…)

Final Rule 506(c) note – disclosure is GOOD.

Yes, it is true that there is NOT a mandatory information disclosure requirement under Rule 506(c) (unlike Rule 506(b)).

BUT, disclosure is GOOD. You should create a proper offering memorandum, private placement memorandum, or term sheet.

- You are taking people's money. They deserve to know what they are investing in. Give them full disclosure.
- A proper disclosure document is good marketing. Shows you are serious.
- The more you accurately disclose, the less you can be sued for.
- ALWAYS TELL THE TRUTH.

THE BOTTOM LINE DOs and DON’Ts.

- **DO** use “Reg D” Rule 506(c) to conduct a “private placement” and raise unlimited capital from an unlimited number of “accredited investors”.
- **DO** verify that these investors are actually accredited – **DON’T** take their word for it.
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