



PROGENY

Progeny provides a crowd-funding portal tailored to the needs of developers that transforms the equity of real estate projects into liquid transferable tokens. The portal provides investors an analytical framework for evaluating the merits and qualities of the projects pitched.

LEGAL MEMO

draft version

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ABSTRACT



The great depression of the 1930s was an outcome of over speculation. Securities were marketed as more valuable than they actually were in get-rich-quick schemes. The key factor in driving the over valuation of securities was a lack of information about the underlying asset's potential and actual performance as well as parade of outright fraud. For this reason the Securities and Exchange Commission was created and tasked with ensuring that all securities marketed widely were properly registered and their financials documented. While a generally straight forward process at first, the registration process has become increasingly complex and expensive, creating significant barriers for early-stage companies to receive seed financing.

In recent years, with the advent of internet-based crowdfunding, the Federal government has provided a number of exemptions for small offerings of securities via online platforms. We hope and expect that with the increased liquidity and transparency provided by blockchain, securities legislation will continue to evolve. For now we intend to make use of exemptions outlined in Regulation D (Reg D) and Regulation A (Reg A) respectively.

REGULATIONS



CROWDFUNDING EXEMPTION

The Crowdfunding exemption passed in the Jobs act of 2012 (which also expanded Reg A) opens solicitations and sales to unaccredited investors, but is significantly limited in the context of real estate due to its limitation to financing projects only up to 1 million. Another downside of using the crowd funding exemption is that you have to use a registered portal. One significant benefit to using the crowdfunding exemption is that portals are additionally exempt from registering as a broker-dealer.

COOPERATIVES

Co-ops appear to be given a broad exemption for soliciting funds for their project's initial creation. The expectation though is that the investors have a direct relationship to the firm and receive indirect monetary benefits. Further, the active relationship the owner has to a proposed co-op is presented as the differentiating factor, as opposed to a passive investment stake, otherwise known as a security. Because of this, historically co-ops and condos have not needed SEC registration even though they represent ownership and can be marketed to new prospective buyers by their current owners and exchanged at will. These extends to housing co-ops and theoretically condominium pre-sales.

REGULATION D

There are two key rules for Reg D offerings, 504 and 506. Rule 504 outlines the broad exemption, and clarifies that any security will not be exempt from state level filings for up to 5 million. 506 allows for unlimited funding if all investors, with the exception of 35 sophisticated investors, are accredited, meaning they have wealth above \$2 million, and no general solicitation takes place. Rule 506 was modified in 2013 to allow for an unlimited offering under two situations, outlined in amendments parts (b) and (c). 506(b) allows for offerings without general solicitation to 35 non-accredited investors if they are provided extensive financial information through a private placement memorandum (PPM). 506(c) is a non-restrictive offering with general solicitation, requiring little to no information disclosure but securities have to be marketed exclusively to wealthy people (accredited investors). For all Reg D offering, securities have to be held for at least 6 months to a year before they can be sold and relevant filings are required for sales above 50k.



REG D REITS: Private REITs are a subset exemption of Reg D. They enjoy a blanket exemption, but they are required to distribute at least 90% of all taxable income to shareholders, annually, 75% of which must come from real estate assets. A qualifying REIT must have at least 55% of its assets in real estate and at least 80% of its assets must be in real estate related assets. For these purposes, qualifying assets generally include mortgage loans and other assets which are the functional equivalent of mortgage loans. Fundamentally, a REIT is intended as to be a passive investment vehicle, and it's legally restricted to activities that reflect that. However, a REIT can own a taxable REIT subsidiary ("TRS"), which is subject to a corporate level tax and may engage in activities that would be impermissible for the REIT itself. Its investment in TRSs cannot exceed 25% of its total gross assets. In general, a REIT would file a registration statement on SEC Form S-11.

REGULATION A

Similar to the crowdfunding exemption, offerings under Reg A allow for solicitation and sales to all investor types, but with the additional advantages of larger-scale financing, the freedom to operate outside the context of third-party portals, and the potential to resell securities under certain circumstances. Due to these abilities, Reg A offerings are often referred to as a 'mini-IPO'. Reg A offerings are distinguished into Tier 1 and Tier 2, which each have their own permissions and requirements.

Tier 1 Exemption: Tier 1 provides \$20 million of financing from normal and accredited investors, without restriction in a 12 month period. Regulation A Tier 1 has no requirement for audited financial statements (just financial statements) and is open to anyone, including non-accredited investors. But a firm still has to register with each state the securities are offered in, and most states have more onerous registration requirements than Tier 2. So while Tier 1 has no restriction on the number of un-accredited investors involved, the need need for state-specific filings are as or more onerous than doing Tier 2 requirements, notably the need for audited financial statements by an independent auditor, and some states may additionally restrict the investor type. It seems only banks who have a pre-exemption to state rules and work locally are using Tier 1. Investors worldwide do not have to comply with state registration requirements, and so Tier 1 might be a viable option if the scope of investment is primarily international.

Tier 2 Exemption: Tier 2 allows up to 50 million of funds to be raised. While Tier 2 offerings are pre-exempt from Blue State laws, a company has to have their financials audited. The complexity of this process scales with the breadth of a company's financial history. While the company can submit few financials to simplify this process, the exemption is subject to continuous review and can be denied if the proposed project does not meet expectations.



Tier 2 covers preferred shares and allows for a structured approach to payout, assuming there is full disclosure. One can create a blanket offering for real estate as long as the proposed projects are substantially related. Thus, Tier 2 provides precedent for a delayed or continuous offering. All security shares under the same exemption have to be set at a firm price for their initial offering. We can request to establish a range or create an amendment to the filings at each new project to reflect a difference in price, but this would be a difficult process to scale.

Secondary trading of securities issued under a Reg A Tier 2 offering may still be subject to relevant local state laws, but the onus for such filings is on the individual and intermediary facilitating the transaction, not the issuer. Rules around secondary trading of these types of securities are in development. The key restriction is that the price for the securities not exceed 30% of the issuing token price. The firm responsible for helping shape these exemptions, Fundrise, used the Reg A exemption to create what they are calling an 'eREIT' that is enabling of investment by unaccredited investors.

"Investors can invest online through a portal with low minimum investments (\$1,000 for Fundrise's eReits and \$2,500 for Realty Mogul's MogulREIT I). While Fundrise operates a separate income (debt) and growth (equity) eREIT, Mogul Realty's REIT includes debt and equity investments. Indeed, Fundrise raised its first \$1 m closing in four hours, stating it was over-subscribed by 400%. By September 2016, it had raised \$90 m from investors, with a waiting list of 60,000 for new fundraising, and has indicated that approximately 75% of its 10,500 investors are seeking to reinvest²⁵." - Real Estate Crowdfunding: Gimmick or Game Changer?, IPF Research Programme 2015–2018

OFFER CIRCULAR AND AUDITED FINANCIAL STATEMENTS

An Offer Circular and financial statements for each developer will need to be provided to investors and the SEC. The SEC Requires that a Business plan be available and in place and that the financial statements comply with AIPC standards. The SEC does not evaluate the merits of an investment, they simply want to make sure that a company has all information disclosed so an investor can evaluate the investment for themselves. If a company has no revenue and no existing financial structure, then their financial statements will simply reflect that.

BROKER DEALER



The one major downside of using Reg A filings, rather than using the Crowdfunding Exemption, is the need to register as a broker-dealer. This is a relatively involved process that FINRA, (self-regulatory organization (SRO), has streamlined considerably. Registering with FINRA will involve fees for as little as 8,000 for small firms like Progeny. FINRA will walk a firm through each step of the process for Federal (SEC) and State filings. FINRA membership also provides SIPC membership.

FINRA requires a distinct name be reserved and that two principals be identified for each broker dealer, one being a financial and one being an operations officer. Any associated persons supporting a broker dealer in facilitating transactions must also register with a U-4 form. Some states may require Series 63 qualification examinations for the financial principle, though not New York. FINRA helps its members remain compliant with Federal and State laws. FINRA requires disclosure of business and contractual relationships, and a level of adequacy of facilities, and communication and operation systems, capital, financial controls, supervisory systems, and record-keeping systems. As with issuing securities, AML/KYC requirements apply to broker dealers and fingerprints of officers must be submitted.

OUR PLAN



The paperwork and documentation required for filing a Crowdfunding exemption is not significantly less than that required for a Reg D or Reg A, but it doesn't work well for real estate because the funding restriction is too low and each proposed project would have to be proposed on another portal that is managed at arms length from the projects pitched. For this reason, while the bulk of the portals instantiated by Progeny will likely be covered as a 'friends and family offering' under Reg D filings, for our larger more ambitions real estate developers who plan to market their securities widely, we plan on following the footsteps of FundRise in automating or facilitating the filing for Reg A exemptions, instantiating each as an 'eREITs'.

STRATEGY

Exemptions registrations are subject to approvals by the SEC based on their perception of the applicant's commitment to company transparency and integrity. We will be presenting blockchain technology as a more efficient and transparent means of meeting compliance requirements rather than an obstacle to it. Having our transaction and dividend data all available on a blockchain for inspection will build more transparency and confidence with investors. Additionally, we can provide support for ensuring compliance beyond our platform by integrating requirements into the code of our smart contracts that ensure trades occur on compliant platforms and don't exceed the price required by the SEC for resales.