

# Finance, Securities, Regulation

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Adam Sterling  
UC Berkeley School of Law



# Introduction

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*UCLA*



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**BerkeleyLaw**  
UNIVERSITY OF CALIFORNIA

**BerkeleyHaas**



# Introduction

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G U N D E R S O N   D E T T M E R



# Introduction

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Berkeley Center for  
Law and Business



# Today's Lecture

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- “Old School” Venture Finance
- Securities Regulation 101
- The Regulation of Blockchain (but mostly tokens)



# My New Startup

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# My New Startup

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# My New Startup

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# My New Startup

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# My New Startup

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# My New Startup

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# My New Startup

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# My New Startup

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hairbnb



# Historical Venture Financing Instruments

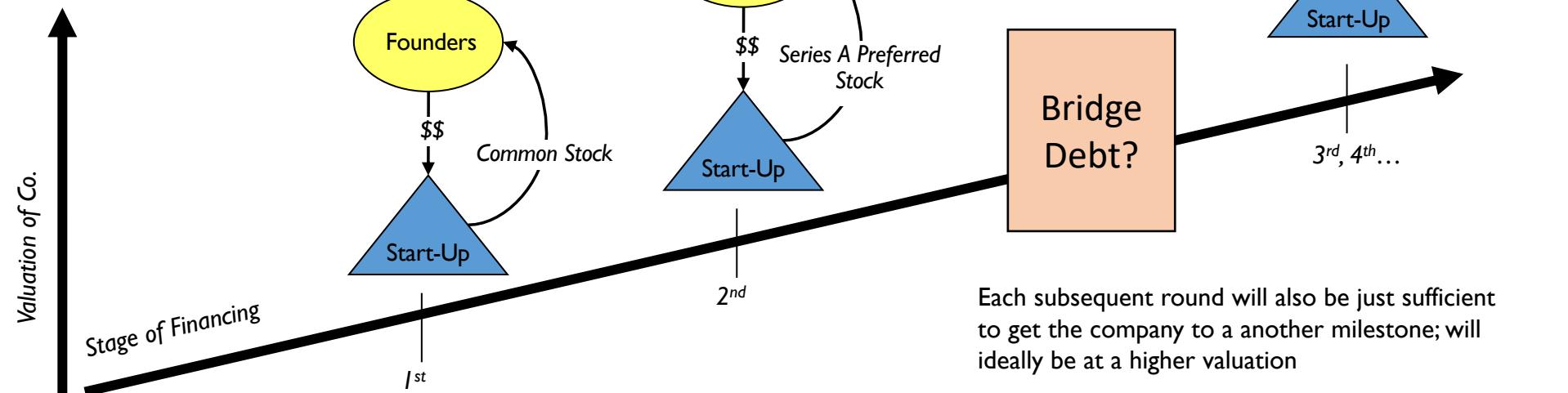
## EQUITY

- 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

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## 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

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## 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

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## Example (continued):

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

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

- 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

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**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?

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## 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

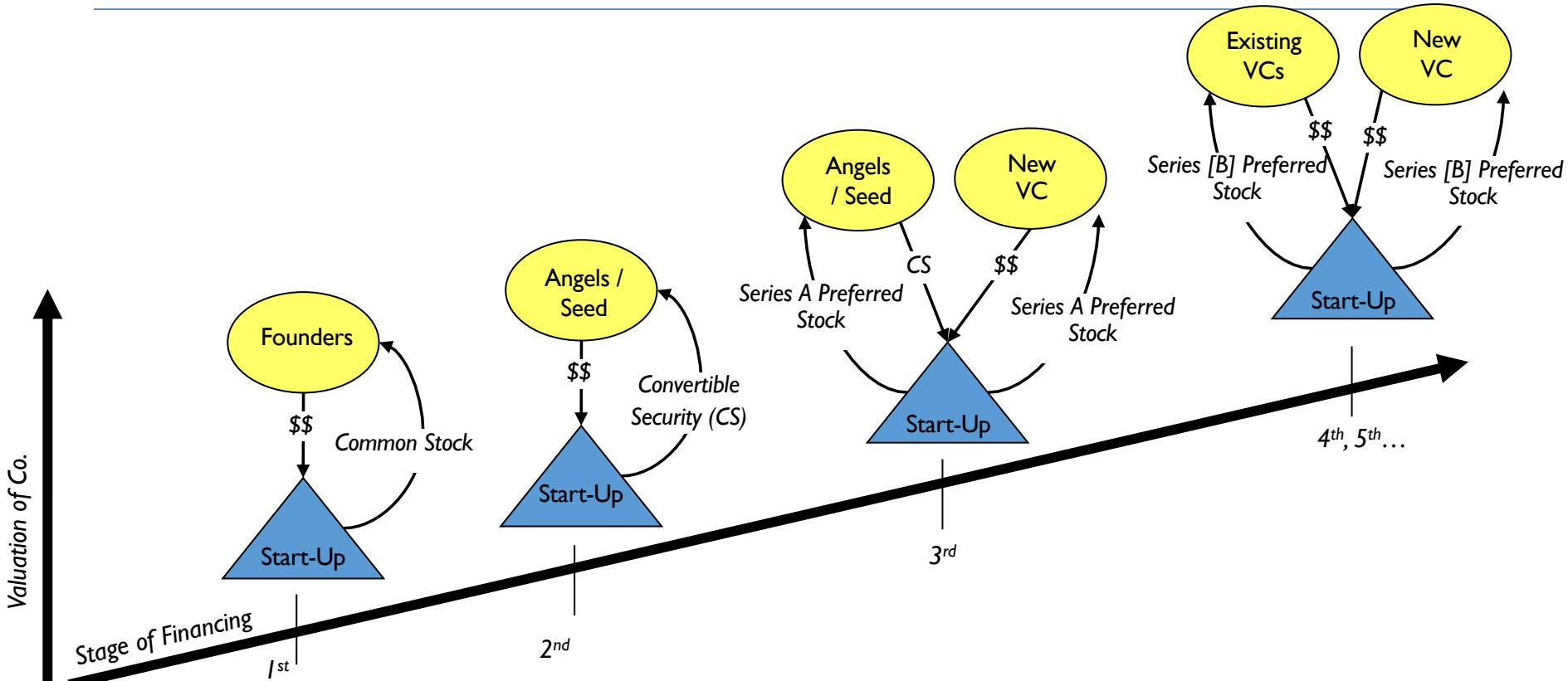
## DEBT

- 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

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## 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

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# 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.  
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. Chiford, Treasurer; Assistant Cashier, City National Bank. O. N. Hayes, Secretary; owner and manager Hayes Advertising Agency. Lamar D. Fain, member firm W. B. McChukan 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.**  
IF YOU WANT IN A GOOD COMPANY—GET IN NOW.

**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**

Gentlemen:—I want ..... shares of your stock and enclose \$..... in full payment at \$10.00 per share.

Name ..... Town ..... (CCC)  
Address .....

## J.S. BLAIN'S Greatest Land Offering Greater than Merritt's Island-Greater than St. Andrews Bay

**\$15 or acre & \$37.50 Balance \$15 Quarters** or the COLUMBIA ACRES COUNTRY RIVER  
Never before have you been offered such an opportunity—perhaps never again! A bargain feast  $\frac{1}{4}$  few days

# 10 Acres for \$150



### FEATURE THE 10 ACRE & \$150 OFFERINGS

Land for sale in the Columbia River Valley, Oregon, and the surrounding areas. The land is located in the state of Oregon, specifically in the Columbia River Valley area. The land is described as being suitable for agriculture, grazing, and other uses. The land is offered at a price of \$150 per acre, with a balance of \$15 per quarter acre.

### Brokers and Subagents

We are pleased to offer our services as brokers and subagents for the sale of land in the Columbia River Valley area. We welcome inquiries from individuals and companies interested in purchasing land in this area.

### —FIRST COME-FIRST SERVED—

**All-Florida Realty Co.**  
201 Louisiana Street, Office  
Apt. 200, San Antonio,  
Texas 78101  
Telephone 210-554-2222



**MAIL YOUR CHECK**  
\$37.50

or the COLUMBIA ACRES COUNTRY RIVER

Never before have you been offered such an opportunity—perhaps never again! A bargain feast  $\frac{1}{4}$  few days

# Quiz Time!

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# What goes up...

Fair, slightly cooler tonight.  
Friday fair. Fresh south-  
west to west winds.  
Temperature, 32 M. (High 55)  
Wind, 10 M. (High 25)  
Mean average 20 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 Unknown Soldiers' Tomb.

#### Hollywood Fire Destroys Films Worth Millions

ATTEMPT MADE ON LIFE

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

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-

#### FEAR 52 PERISHED IN LAKE MICHIGAN; FERRY IS MISSING

Wreckage Picked Up Indicates Craft Went Down With All Aboard.

Milwaukee, Wis., Oct. 24 (AP)—Horse-drawn car ferry Milwaukee of the Grand Haven Line, which went aboard, had weathered the 48-hour storm on Lake Michigan faded today with a report that wreckage from a boat had been picked up 10 miles off Wind Point, which is about 4 miles east of Green Bay.

#### PIECE OF PLANE LIKE DITEMAN'S IS FOUND AT SEA

Black and Orange Wreckage Indicates Daring Flier Went to Death.

St. John's, N. F., Oct. 24 (by the Canadian Press)—The report from Harbor Grace that the S.S. Kyle had found a mangled mass from an unidentified airplane from an unidentified source was contradicted. The finding of airplane wreckage was stated by the Newfoundland management to be without foundation.

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

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

FOR MORE LOBBYISTS

Eagle Bureau, Capitol Bldg., Washington, Oct. 24—Jo-

#### STOCKS CRASH IN RUSH TO SELL; BILLIONS LOST

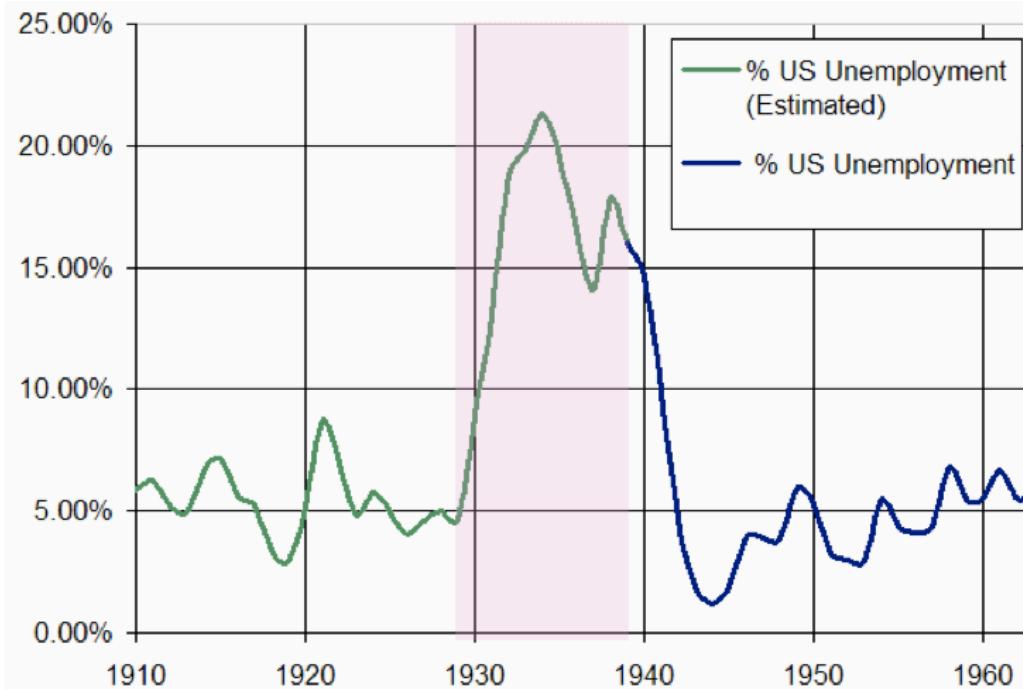
Morgan, Mitchell Buying Stocks in Effort to Check Rush to Unload.

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 distress selling. Bankers were offering some support, but admitted the situation had gotten beyond them.

Charles E. Mitchell



# What goes up...



Source:  
Business Insider

# The Securities Act of 1933

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# The Securities Act of 1933

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## “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

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## **Penalties may include...**

- **Injunction and Trading Suspensions**
- **Officer and Director Bars**
- **Civil/Monetary Penalties (including disgorgement)**
- **Criminal Penalties**



# The Securities Act of 1933

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**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

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## 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

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**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



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# The Securities Act of 1933

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# What is a Security?

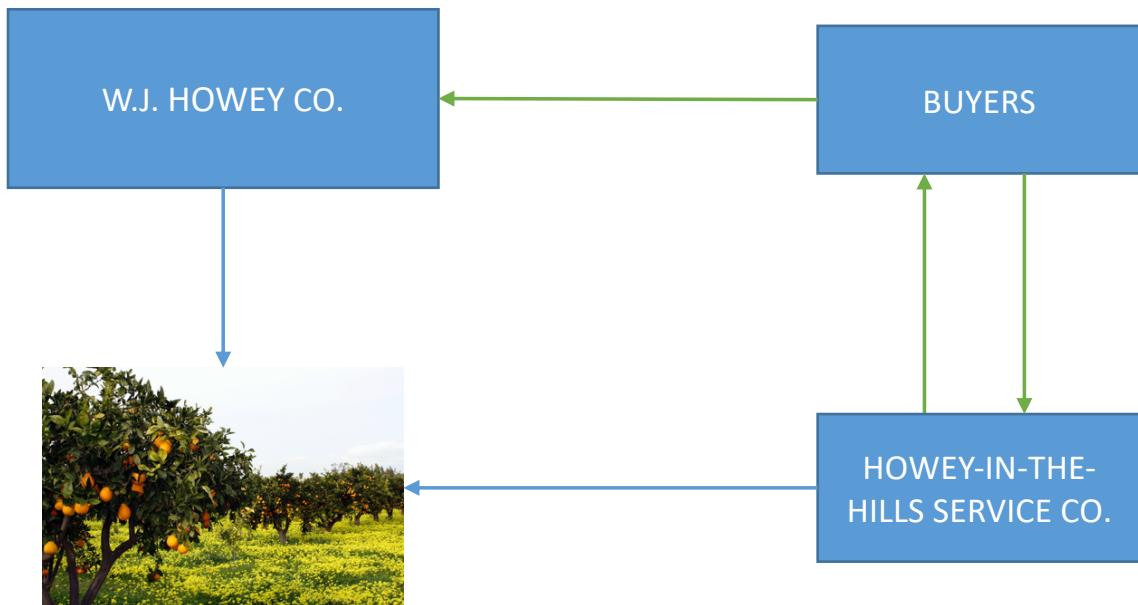
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*Securities and Exchange Commission v. W.J. Howey Co., 328 U.S. 293 (1946)*



# SEC v. W.J. Howey Co.

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# The *Howey* Test

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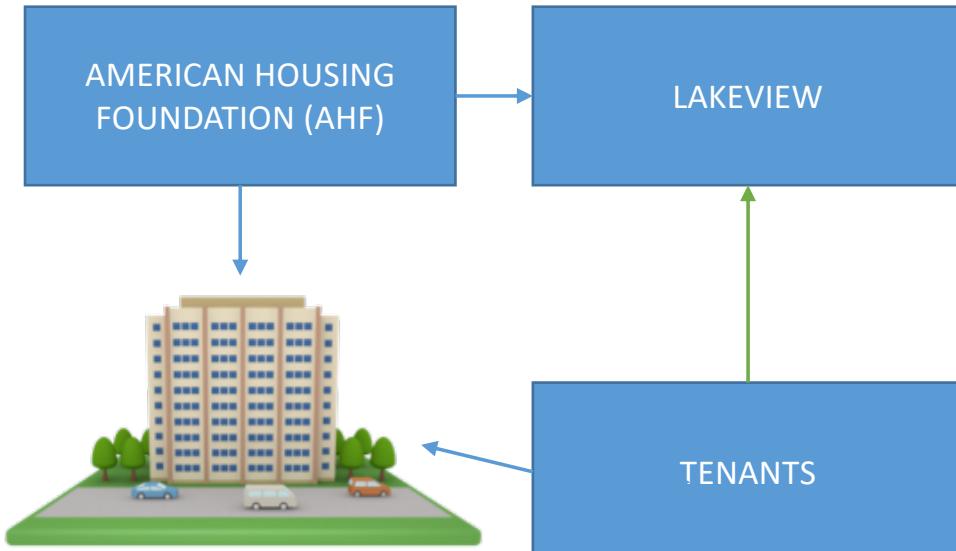
An “investment contract” is any contract of profit-making scheme whereby:

- (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

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- 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

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<https://pollev.com/adamsterling224>



# The Securities Act of 1933

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- 1) You file a registration statement; or
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# The Securities Act of 1933

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## 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

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# Token Sales

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*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!

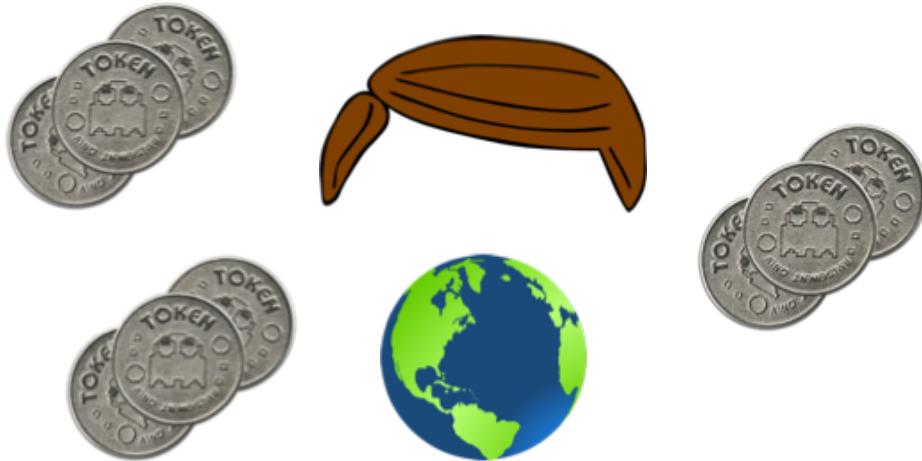
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*The public token sale, colloquially known as an “Initial Coin Offering,” is a powerful new tool for creating decentralized communities, kickstarting network effects, incentivizing participants, providing faster liquidity to investors, and forming 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.

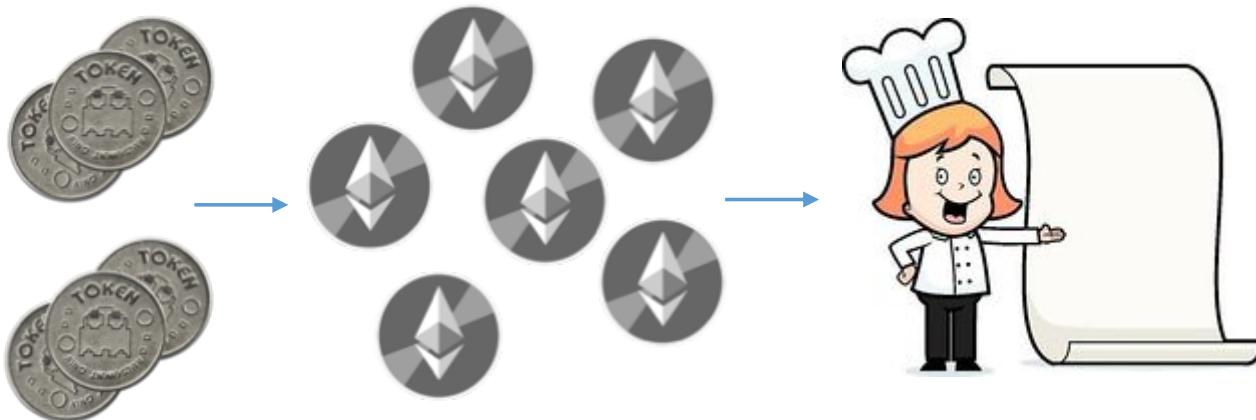
# Moot “Crypto” Court

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<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

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- 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

