AERY
ADVISORS

FOUNDATIONAL KNOWLEDGE OF VENTURE FINANCE

Module 2

Module 2: Foundational knowledge of venture finance

Choice of Jurisdiction, Choice of Entity & Basic Building Blocks

Lesson 1

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Choice of Jurisdiction

- Jurisdiction can be “strategic” to your business.
- Where do you want to base your headquarters?
- Where do you want to hold your IP?
- Where do you want to seek funding?
- How will choice of jurisdiction impact eligibility to access third-party programs, services, tax credits and the like?
- Important: Seek objective advice from qualified legal, accounting, tax and other financial advisors to make informed choices.

Choice of Entity

- Tax considerations.
- Limitation of liability and other civil law considerations.
- Initial capitalization and annual cost considerations.
- Access to third-party financing considerations (some sources of financing may limit their activities to companies organized within their home jurisdiction or selected jurisdictions).

Choice of Entity

Two basic forms:

1. Corporations
2. Pass-through entities (in USA these include: general partnerships, limited partnerships, limited liability partnerships, limited liability companies (similar to German GmbH))

- Jurisdictional differences: most countries have both corporate and pass-through forms of business organization, but it's important to understand different civil and tax implications.
- Important: Seek objective advice from qualified legal, accounting, tax and other financial advisors to make informed choices.

Basic Building Blocks

Corporate Form – Corporations (similar to a German AG)

- Common stock (ordinary or voting shares)
- Convertible debt or convertible notes
- Preferred stock

Common Securities and Instruments Overview

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Common Securities and Instruments Overview

Common stock/ordinary or voting shares.

Convertible debt/Convertible notes.
SAFE – Simple Agreement for Future Equity (four versions).
KISS – Keep It Simple Security (equity and debt versions).
SAFT - Simple Agreement for Future Tokens.
Revenue backed note (like a “royalty,” but with a ceiling).
Series Seed.
Preferred stock (including convertible preferred stock).
Venture debt and venture leasing.
ICO/STO – Initial Coin Offering/Security Token Offering.

Key Economic Terms and Conditions

Lesson 3

Key Economic Terms and Conditions

Reverse vesting of founders' stock – helps co-founders hold each other accountable (Angels and VCs like it, too).

Anti-dilution provisions (narrow, broad or weighted average).

Liquidation preferences (straight, participating or capped) – drives the "waterfall" upon a liquidity event.

Pay-to-play provisions (really works "among the investors," penalizing those who will not, or cannot, participate in future financings; elements of "deep-pocket poker strategy".)

Key Control Terms and Conditions

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Key Control Terms and Conditions

Various ways to share control

Contractual agreement for “protective provisions”, such as:

- Board of directors (who, how many, removal only for “cause”?)
- Drag-along rights (what, when, who?)
- Conversion rights (mandatory vs option of holder, when, how?)

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Other Negotiable Terms and Conditions

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Other Negotiable Terms and Conditions

Dividends

- For most startups and emerging growth companies, not commonly paid b/c retained earnings fuel growth.
- ”Cumulative” dividends are like compound interest – they may not get paid out until a liquidity event.
- Who decides – board of directors, and how might fiduciary duties impact deliberations?

Redemption Rights

- Generally not exercised, but can be used as “lever” to force board to consider “strategic alternatives,” including sale of company, IPO or recapitalization.
- Typically not exercisable for at least 5-7 years.
- Not “common” in Silicon Valley, but not uncommon in many places globally.

Other Negotiable Terms and Conditions

Milestone based financing

- Can be used to minimize risk to investors that venture fails to execute as planned.
- Problem in dynamic markets where venture may need to "pivot."
- How will "valuation" be determined, and is the financing an "option by company" or "mandatory if milestone met"?

Information rights

- What kind of information is required (e.g., financial statements (reviewed or audited), business plan), and how often (monthly, quarterly or annually)?

Other Negotiable Terms and Conditions

Registration Rights

- Enables holders to ”register” shares for resale to public – provides “liquidity” for “restricted securities.”
- Only important if the company “goes public” (e.g., IPO or backdoor); can be a big deal in that case, otherwise not relevant.
- Another way to participate in IPO upside is “Friends and Family” or “Directed Shares” programs.

Rights of First Refusal

- Can be “contractual” or provided by corporate statute (“pre-emptive”).
- Valuable to investors, but can slow down and impede ability to attract new investors (because need to be able to bring in new % ownership).

Other Negotiable Terms and Conditions

Voting agreements

- Can cover any number of things, usually the election of Directors, but also relate to strategic decisions such as whether to sell the company ("drag-along rights").
- Can be structured in a standalone agreement with just major investors, or as part of a larger shareholders' agreement.
- Recent trends and controversy in Silicon Valley and Wall Street re founder "super-voting" rights or classes of shares (e.g., WeWork).

Restrictions on Sales (Rights of First Refusal)

- The value of a security is impacted by the ability to resell it (through public or private markets) – non-marketability discounts.
- Closely-held companies, and VC-backed companies, desire to control who has equity and voting rights.
- Emergence of "secondary markets", including "tokenization" are driving "innovation."

Other Negotiable Terms and Conditions

Proprietary Information and Inventions Assignment Agreement (PIIAA)

- Ensures that the company actually owns its intellectual property (IP).
- Prevents IP “side hustles” and “conflicts of interest.” Also, consider “restrictions on outside activities.”
- Important that ”EVERYONE” involved in IP creation signs.
- Sloppy PIIAA practices sink and complicate deals, public and private (e.g., Skype-eBay IP litigation).

Co-Sale Rights

- If another investor negotiates a deal to sell some or all of its equity, can other shareholders “piggy-back” on the deal?
- Agreements that seek to align interests of investors, or at least ”major investors”, to enable sharing of any “control premiums” and opportunities to achieve liquidity outside of a “sale of the company” or ”public offering.”

Other Negotiable Terms and Conditions

No-Shop Agreement

- It is fairly common for investors to want a ”reasonable” period of ”exclusivity” to conduct reasonable due diligence and negotiate binding legal agreements, without fear that the deal embodied in a term sheet will be ”shopped” by the company to other investors.
- In our masterclass, we learn that raising venture financing is a numbers game, and the hardest thing to do is to get the first prospective investors to say “Yes, I’m committed.” The ”No-Shop” is reasonable, assuming it is limited to the earlier of 4-6 weeks, or the date when the investor abandons the deal/commitment. Proving abandonment is hard, but ”you know it when you see it.”
- The flip-side of the coin is “Non-Assignment” of the Term Sheet; the “people” behind the investment is important, so it is customary to provide that the investor cannot “flip” the term sheet to non-affiliated investors.

Sweat Equity

Lesson 6

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Sweat Equity

In any “knowledge-based” company, the most important assets “walk out the door every night.”

One of the biggest challenges and risks for such ventures (private or public) is the ability to “attract, retain and motivate” highly-skilled people (whether they be co-founders, early employees, contractors, advisors or professional service providers).

One way to do this is through “sweat equity.”

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Sweat Equity

Some common ”sweat equity” compensation options include:

- Stock options
- Restricted stock
- Phantom stock

Sweat Equity

Equity Compensation is Complicated!

There are many issues to consider:

- Business issues, such as “vesting and/or reverse vesting,” and “Fair Market Value” determinations (including 409A).
- Tax considerations and reporting.
- Securities law disclosure and filing requirements.
- Accounting and financial reporting (both for company and individuals).
- And, the considerations/consequences vary by nation and state!

Bottom Line: Seek objective advice from qualified legal, accounting, tax and other financial advisors to make informed choices.

Innovation in Venture Finance

Lesson 7

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Innovation in Venture Finance

Rise and Fall of ICO Financing

The Boom – Almost US$20B Raised (2015-2018)

- “Money for Nothing” – Whitepapers and Dreams
- Crowdfunding
- “Damn the securities laws”
- Changing the world, and unlocking new asset classes for the masses
- Decentralization and democratization

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Rise and Fall of ICO Financing

The Bust – (late 2018 to present)

- “Meet the New Boss…Same as the Old Boss” (i.e., securities regulators)
- Lawsuits initiated globally, by federal and state securities regulators, alleging fraud and unlawful sales of unregistered securities.
- Appetite for new ICOs, especially, in developed world, dries up.

US SEC Spotlight on Initial Coin Offerings (ICOs)

https://www.sec.gov/ICO

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The Emergence of the STO – Security Token Offering

The Awakening (late 2018 to present)

- Realization by promoters that financing blockchain projects are not that different from other "risk capital" offerings.
- Acknowledgement that securities law compliance is required.
- Seeking ways to make the process easier, but still compliant, with global securities regulators.

Innovation in Venture Finance

The Emergence of the STO – Security Token Offering

Current State and Implications

- Defining what is the “security” being offered.
- Proper planning, financial and managerial, to comply with the regulatory burdens.
- Not that different than a traditional Initial Public Offering (IPO).
  - Disclosure of merits and risks.
  - Legal, accounting and “investment banking like” service providers.
  - Listing on exchanges to provide secondary market liquidity.
  - Regulatory arbitrage, to a certain extent, with nimble (e.g., “entrepreneurial” or “forward-thinking”) jurisdictions leading the way.

Summary of Foundational Venture Finance Knowledge

Lesson 8

Summary of foundational venture finance knowledge

- It is important to choose your jurisdiction of organization, and the type of entity, carefully.
- The basic building blocks for the corporate entity are: common stock/ordinary shares; convertible debt/notes; and preferred stock (including convertible preferred stock).
- Almost anything can be negotiated and structured.
- Organize your negotiating posture in two ways: economics and control.

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Summary of foundational venture finance knowledge

- Equity compensation can be a powerful tool to attract, retain and motivate talent, but be careful – "sweat equity" is complex and requires sophisticated legal, tax and accounting advisors in each jurisdiction.
- There are new innovations in venture finance – including ICOs (boom and bust) and STOs (still emergent) – and there is a regulatory arbitrage ongoing among nations that want to attract blockchain ventures.