



HYBRID TOKEN OFFERINGS: THE RISE OF TOKEN OFFERINGS FOR VENTURE BACKED-COMPANIES

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The use of distributed ledger technology to tokenize products and raise non-dilutive capital was a major new development for technology startups in 2017. Initial coin offerings, or ICOs, and then SAFT (Simple Agreements for Future Tokens, where tokens would be issued in the future) became the primary vehicle for raising significant amounts of capital in 2017 in the early-stage sector of the venture capital markets for blockchain companies, exceeding the amounts raised through traditional pre-seed, seed and angel rounds for equity or equity-linked securities.

Although publications have reported different numbers about the amount raised through ICOs and SAFTs in 2017 (ranging from \$4 billion to \$6 billion), the Wall Street Journal recently noted that companies raised \$6 billion in ICOs in 2017. This new funding option poses challenges for traditional financial venture capital and corporate venture capital investors. Many of the ICOs and SAFTs in 2017 were for the first amount of capital for the companies involved, and most of these companies did not have any traditional venture capital investors in their capital structure.

We are seeing a new parallel trend, however, that is now emerging for startups with traditional venture capital funding: these companies are exploring how to “tokenize” their business to use blockchain technology and raise non-dilutive capital through a token generation event (these token offerings have been described as “reverse icos,” but we believe that a more descriptive name is a “hybrid Token Offering”). These hybrid token offerings raise numerous questions for traditional investors, from control of the token “issuer,” the terms of the offering, and the allocation of “tokens” for management of the venture backed startup (portfolio company). The rise of blockchain has been disruptive to business in numerous industries, from the way startups obtain funding to venture capital strategy. The rapid changes in technology and innovation have raised legal issues that the current regulatory regime was not designed to address.

Introduction to blockchain technology

Blockchain is a decentralized, distributed ledger on which transactions are recorded. The transaction ledger is maintained simultaneously across a network of unrelated computers or servers called nodes, like a spreadsheet that is duplicated thousands of times across a network of computers. The ledger contains a continuous and complete record (the chain) of all transactions performed which are grouped into blocks. A block is only added to the chain if the nodes, which are members in the blockchain network, reach “consensus” on the next “valid” block to be added to the chain. A transaction can only be verified and form part of a candidate block if the required percentage of nodes on the network under such network’s protocol confirm that the transaction is valid; the method of determining this issue is called the “consensus protocol.”

Gartner recently predicted that distributed ledger technology’s business value will grow to \$176 billion by 2025, and noted that blockchain technology is on a clear path toward broad adoption, with use cases of increasing scope, scale and complexity. The recent success of Telegram’s ICO in which the pre-sale reportedly raised \$850 million, is an example of the potential for this method of funding.

The legal status of tokens remains uncertain, with a number of regulators claiming jurisdiction over token sales, from the SEC to the CFTC to state security regulators. Companies selling tokens in ICOs in the first part of 2017 often acted on the presumption that tokens they sold were not securities, but rather that they were “utility tokens” similar to Kickstarter projects and, thus, not subject to the securities laws.

In July 2017, the SEC issued a report after investigating tokens offered and sold by a “virtual” organization known as the DAO. The SEC found that the DAO’s tokens were securities and subject to federal securities laws, and the tokens in such ICOs would need to be registered with the SEC unless a valid exemption applies to the offer and sale of the tokens. In December 2017, the SEC issued another enforcement action after investigating tokens offered by Munchee Inc.. Munchee emphasized in its advertising that investors could expect the tokens to increase in value, the company would create a secondary market for the tokens, and the company led investors to believe their investment in tokens could generate a return. The SEC once again found a token to be a security.

When is blockchain technology for a portfolio company?

Portfolio companies should examine a number of key issues before attempting to integrate blockchain technology into their business. First, the portfolio company should assess whether its business can use blockchain technology and the business goals that blockchain technology will help it achieve. Second, the portfolio company should consider industry-specific issues that may arise in “tokenization” of its product. For example, a portfolio company focused on infrastructure technology should consider whether transmitting data through blockchain technology poses any security, traceability or privacy concerns. A portfolio company focused on financial services should consider how to implement settlement, custodianship and speed. Third, the portfolio company should consider whether the company can handle scalability given the current limitations of blockchain technology.

When should a portfolio company consider an ICO?

Portfolio companies should consider ICOs only when the portfolio company has a problem that ICOs and “tokenization” can solve. One major issue that ICOs may solve is the “cold start problem”: the challenge of creating a new business based on a network that must attract large numbers of users, or a critical mass, to bring a product to market. ICOs can help solve the cold start problem by providing a financial incentive for users to join the portfolio company’s network and become stakeholders even before launch.

ICOs can also solve the challenge in finding early stage funding in the traditional venture capital ecosystem by providing a source of capital even before product launch. Moreover, they can accelerate what has otherwise become increasingly long delays before founders and investors can obtain liquidity for their investments. ICOs have dramatically improved the speed of liquidity for portfolio companies. Currently, the average period to liquidity for startups either through an IPO or an M&A transaction has increased to over ten years (in contrast to five to seven years in the 1990s); however, a company could obtain liquidity with a token offering within months after completion of the offering.

Considerations for hybrid token offerings

Boards of directors of portfolio companies should consider a number of new issues when deciding whether to have a portfolio company pursue a hybrid token offering:

1. Identity of issuer of the tokens: Although some portfolio companies will issue the tokens themselves, many portfolio companies are considering using issuers located in countries with favorable tax regimes, such as the Cayman Islands, British Virgin Islands or Gibraltar. Other portfolio companies are issuing the tokens through an “independent foundation,” such as we saw in the Tezos and the Kik token offerings. Initially, the selection of an independent foundation was meant to reduce the possibility of the tokens being considered “securities.” More recently, however, portfolio companies are selecting independent foundations to manage the development of blockchain projects based on open source licensed software. This structure is similar to many traditional open source projects, such as the OpenStack Foundation, HyperLedger Project (hosted by the Linux Foundation) and Apache Software Foundation.

2. Tokenomics: The terms of the token offering and, in particular, the role, features and purpose of tokens (referred to as tokenomics), can include decisions such as whether the number of tokens is “capped” and, if not, how any limitation on the number of tokens can be determined. The allocation of the tokens is a critical decision. Allocation varies widely, and frequently depends on the business model for the specific blockchain project. The most common categories are (i) developers of the blockchain project; (ii) “miners” to run the blockchain project; (iii) research and development for future development of the blockchain project; (iv) governance, grants and community development (frequently, through a separate foundation); and (v) investors.

3. Management incentives: Will the tokens reserved for management incentives be subject to vesting? For how long? Will there be performance conditions? If the tokens are not subject to time- or performance-based vesting, they will provide immediate liquidity to the management and undercut the careful incentives established through vesting of common stock.

4. Managing the tokenomics of the blockchain project: The portfolio company or the issuer needs to consider how to manage tokens as incentives in the blockchain project. These issues include vesting, “mining” and other “use” incentives. The role of the portfolio company in managing these incentives, particularly when the issuer is “independent,” is a critical issue.

5. Blockchain project – portfolio company exit: The blockchain project may be a significant asset of the portfolio company. The ability of the portfolio company to include the blockchain project or “control” of the blockchain project may be critical for a successful exit for the portfolio company.

Control of Future Hybrid Token Offerings

The National Venture Capital Association has recognized the potential for increasing use of hybrid token offerings by including a new “protective provision” in the latest version of its standard venture capital transaction documents published on February 7, 2018. The protective provision in the NVCA form of the Certificate of Incorporation gives the investors a “veto” over “token offerings”:

3.3.5 cause or permit any of its subsidiaries to, without approval of the [Board of Directors, including the Series A Director], sell, issue, sponsor, create or distribute any digital tokens, cryptocurrency or other blockchain-based assets (collectively, “Tokens”), including through a pre-sale, initial coin offering, token distribution event or crowdfunding, or through the issuance of any instrument convertible into or exchangeable for Tokens.

Many of these issues are still evolving, but we anticipate that during 2018 the venture capital industry will develop a set of industry norms for conducting Hybrid Token Offerings. It is less clear whether the SEC will provide more guidance on the application of securities laws to token offerings. Indeed, senior members of Congress have called for government oversight, enforcement and regulation. In the interim, startups and venture capital investors will need to carefully consider how to integrate traditional venture funding with any token offering.

Learn more about the implications of these evolving issues by contacting any of the authors.

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