

# EQUITY-BACKED TOKENIZATION: A HYPOTHETICAL CASE STUDY

Company A is a Delaware Corporation that operates a growing chain of hotels and wishes to accelerate its growth through the acquisition of some smaller, regional competitors. The company is profitable but does not currently generate sufficient funds to execute its strategy. There is a funding shortfall of close to \$50MM.

The company has been looking into the various financing alternatives available to it, specifically the option to conduct an IPO or a Private Offering. The company has concluded that an IPO would provide the company with the required liquidity, but would entail prohibitive costs and onerous operational & reporting requirements and is therefore not the best option for them, especially for a raise of this size. The Private Offering option provides the company with the ability to remain private, but the company's true market valuation will suffer due to the offering's lack of built-in liquidity features, and the slow and bureaucratic processes prohibiting secondary trading of the shares.

Initial Coin Offerings (ICOs) do not follow Securities regulations as they argue that the issued tokens are not securities but rather serve a function - a utility - on the issuer's platform. For example, Company A would have to structure their offering in such a way that their tokens would be used to pay for rooms in their hotels. Furthermore, even if the offering were structured as to enable such a utility and convince the regulators that token holders were not buying tokens as an investment, it is unclear what regulations, if any, should apply to such an offering.

Fundraising Alternative	Pain Points	Securitize Value Proposition
IPO	<ul style="list-style-type: none"> <li>• High costs</li> <li>• Onerous reporting</li> <li>• Operational reporting</li> <li>• Single geographic location</li> </ul>	<ul style="list-style-type: none"> <li>• Keep higher % of raise</li> <li>• Remain private</li> <li>• Generally global reach</li> </ul>
PRIVATE OFFERING	<ul style="list-style-type: none"> <li>• Limited liquidity</li> <li>• Single geographic location</li> </ul>	<ul style="list-style-type: none"> <li>• Day 1 liquidity</li> <li>• Generally global reach</li> <li>• Lower transaction costs</li> <li>• Improved efficiency</li> </ul>
ICO	<ul style="list-style-type: none"> <li>• Legal risks</li> </ul>	<ul style="list-style-type: none"> <li>• Regulatory compliance</li> </ul>

Research shows that restricted shares are undervalued by 20% - 35% due to their lack of liquidity in comparison with ordinary shares.\*

Frustrated by these difficulties and lured by the seemingly easy access to capital that Initial Coin Offerings (ICOs) offered, Company A started considering this as an option. However, regulatory uncertainty and the lack of any discernible "utility" in their planned offering quickly shut that door.

\* The Cost of Illiquidity, Aswath Damodaran, NYU Stern



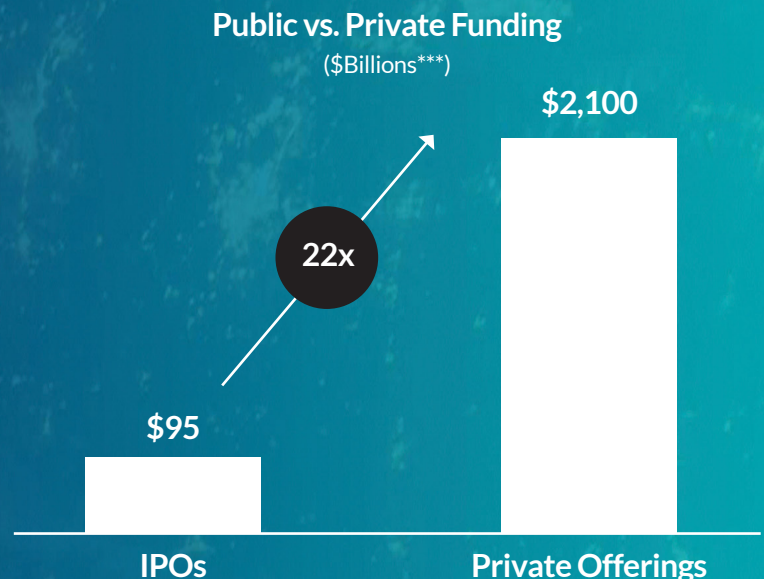
# STOs: THE SECURITY TOKEN OFFERING

Faced with concerns regarding traditional and even some new forms of access to capital, the company was presented with a new and improved method of fundraising: The Security Token Offering, or STO. Like the ICO, the STO promised to bring together the liquidity associated with IPOs, and the costs and lack of operational implications of Private Offerings. However, unlike the ICO, the STO did not require the company's token to have any "utility," and it was conducted in compliance with existing Securities regulations in each territory.

	IPO	PRIVATE OFFERING	ICO	STO
Approximate Cost Over 10 Years*	\$21MM	\$5MM	\$2MM	\$5MM
Time Required	12-24 Months	2-6 Months	2-6 Months	2-6 Months
Operational Impact	High	Low	Low	Low
Geography	1 Country	1 Country	Multiple	Multiple
Regulatory Uncertainty	Low	Low	High	Low-Mid
Liquidity	High	Low	High	Mid-High**
Required Track Record	Yes	No	No	No
Only Accredited Investors?	No	Mostly	No	Mostly

The main concern Company A had with the STO option was that it was limited to 2,000 Accredited Investors, which is a regulatory limitation placed on private offerings, but this concern quickly dissipated when the company found that the private offering market in the US was 22X bigger than that of public offerings.

Interested in the prospects of the STO, Company A started looking into the process and costs involved.



\*Sources: PwC, Securitize analysis

\*\* Dependent on speed of Security Token Exchanges rollout

\*\*\*2014 figures. Source: PwC





# HOW DO YOU ACTUALLY DO AN STO?

Working with Securitize, Company A followed a 3-step process for setting up, executing, and managing its STO:

## Pre-STO

In the set-up phase, Company A focused on structuring the offering, creating or changing the required documentation, obtaining legal reviews for the process, and setting up marketing activities.

## Issuance

The STO itself consists of issuing the tokens, conducting KYC/AML/Accreditation processes for the investors, and managing the flow of capital and tokens between Company A and its investors.

## Lifecycle Management

Once the tokens are issued, the investor lifecycle needs to be managed, including investor communications and secondary trading compliance.

Below is a step-by-step breakdown of the process followed by Company A:

## Pre-STO

### 1 COMPANY CHARTER

The issued tokens will represent company stock. Therefore, Company A needs to issue enough stock to perform the issuance, as well as define their specific rights as the company would do for any other stock: Are they preferred or ordinary? Do they carry voting rights? Do they pay dividends? This may or may not require making changes to the company's charter. In the case of Company A, the company had 100,000,000 authorized shares and only 10,000,000 issued shares, and the company decided to issue 50,000,000 additional restricted shares with no voting rights, at a nominal value of \$0.0001 for the purpose of the STO.

### 2 STO DOCUMENTS

Next, Company A had to define the terms of the offering and reflect those terms, as well as some additional items in their Offering Memorandum. This document is substantially less comprehensive than the prospectus, used for public offerings, **and includes:**

#### > COMPANY OVERVIEW, RISKS, AND FINANCIALS:

An overview of Company A's business, its business risks, and its financial reports.

#### > OFFERING DETAILS:

In this case, the company decided to conduct an STO under Regulation D, Rule 506(c), since this allowed them to perform solicitation for their offering. **The terms were:**

##### > Minimum Investment Size:

\$50,000. This was set to ensure that valuable investor slots are not taken up by small investors.

##### > Rights:

No dividends or voting rights were granted. Standard drag-along rights were granted.

##### > Obligations:

Company A established the right to buy back the tokens in certain cases and to block them if investors do not complete their KYC/AML/Accreditation process or do not sign the Subscription Agreement.

##### > Transfer Rights:

Secondary trading is restricted to trades permitted by the existing securities regulations.



› **Price:**

A price of \$1 per token was set, in order to facilitate the \$50MM raise.

› **Accepted Currencies:**

Company A decided to allow investors the flexibility to invest using USD, BTC or ETH.

› **Cap:**

The limits set for the raise.

› **Closing Date:**

The date at which the offering ends.

› **Use of Proceeds:**

Proceeds were tentatively earmarked to perform a series of M&A transactions.

## ➤ **LEGAL DISCLAIMERS**

Company A engaged outside counsel to assist with drafting the standard Private Offering legal disclaimers along with some additional disclaimers relating to the token offering.

## ➤ **SUBSCRIPTION AGREEMENT:**

During the STO, investors may be required to sign the Subscription Agreement, which is a separate document that summarizes the terms of the investment and captures the investor consent to those terms.

## 3 **MARKETING**

Since Rule 506(c) allows for general solicitation, Company A created a marketing plan and set aside a budget. However, due to the cap on the number of investors, these marketing activities were more focused and cost-effective than those surrounding an ICO. Overall, Company A spent \$250,000 on marketing its offering, which included the engagement of a broker dealer. Company A chose to use the white label Landing Page provided by Securitize's in order to manage investor onboarding.

## Issuance

### 1 **KYC/AML/ACCREDITATION**

STOs are limited to Accredited Investors, or Qualified Investors in Europe. Working with Securitize, Company A seamlessly managed the KYC/AML/Accreditation process and created investor accounts on the platform for each investor that cleared the process.

### 2 **TOKEN ISSUANCE**

Company A used Securitize's standard smart contract, which its counsel had confirmed to included all necessary global compliance requirements, such as limits on investor counts, lock-up periods, and flowback restrictions. The smart contract was then tweaked to facilitate the buyback powers the company wanted.

### 3 **FUNDING**

The process of collecting funds from interested investors and distributing the issued tokens to investor wallets was handled end-to-end by Securitize, in compliance with the requirements defined in the set-up phase by Company A. In addition, since Company A preferred not to hold all the funds collected in BTC & ETH on their Balance Sheet, they opted to use the 3rd party Custodian service that was offered through the Securitize platform.



## Lifecycle Management

STOs don't require anything resembling the ongoing effort associated with public offerings, but there are certain life cycle implications that do have **to be addressed**:

### 1 ONGOING COMMUNICATIONS

From time to time, Company A may need to communicate with investors. The details of these communications are generally defined in the Offering Memorandum and may include sharing periodic financial reports or certain event-triggered communications, such as those involving buy-backs. The company opted to use Securitize's community management solution in order to mitigate this concern.

### 2 SECONDARY TRADING

Restricted shares have certain limitations on secondary trading such as lock-up periods and caps on investor counts in different geographies. Managing these complexities can be unbelievably daunting, but fortunately Company A's counsel confirmed that the secondary trading restrictions baked into the Securitize smart contract were fully compliant.

## STO Process Overview and Timelines

		Estimated Time	Responsible	Securitize Role
Pre-Sto	Company Charter	1 Week	Company, Counsel	Advise / Knowledge Sharing
	Offering Documents	1 Month	Company, Counsel	Advise/Knowledge Sharring
	Real-Estate Specific Setup	0-4 Weeks	Company, Counsel, Securitize Partners	Support
	Marketing	3 Month	Company, Broker-Dealer	None
Issuance	KYC/AML/Accreditation	Ongoing	Securitize	Lead
	Token Issuance	1 Day	Securitize	Lead
	Funding	1 Day	Securitize	Lead
Total Time From Kick-Off Until Issuance: 2 - 6 Months				
Life Cycle Management	Ongoing Communications	Ongoing	Securitize/Company	Execution
	Secondary Trading	Ongoing	Securitize	Lead

## Conclusion

**Company A successfully** concluded its raise, issuing **50MM** tokens for a consideration of **\$50MM**. The process was completed in a little over 2 months, with the main time-consuming activities being the preparation of the Offering Memorandum and completion of legal reviews.

Although there are currently no operational exchanges trading in compliant security tokens, there are several such exchanges that are expected to go online by the time the lock-up period for Company A shares expires.

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