

WilmerHale and FTI Consulting Webinar: Unicorns and Digital Coins: Exploring the Strange New Regulatory World of Private Companies

Thursday, May 17, 2018

Speakers:

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Webinar Guidelines

- Participants are in listen-only mode
- Submit questions via the Q&A box on the bottom right panel
- Questions will be answered as time permits
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Agenda

- I. The Unicorn Landscape
- II. Unicorn Companies: Invincible Against SEC Scrutiny?
- III. Transitioning From Private to Public
- IV. Trump Administration: Current SEC Environment
- V. Takeaways
- VI. Questions?

I. The Unicorn Landscape

What is a Unicorn?

Definition: Private companies valued at \$1 billion or more. The billion-dollar technology startup was once the stuff of myth. Today they're seemingly everywhere, backed by bullish capital and a new generation of disruptive technologies.

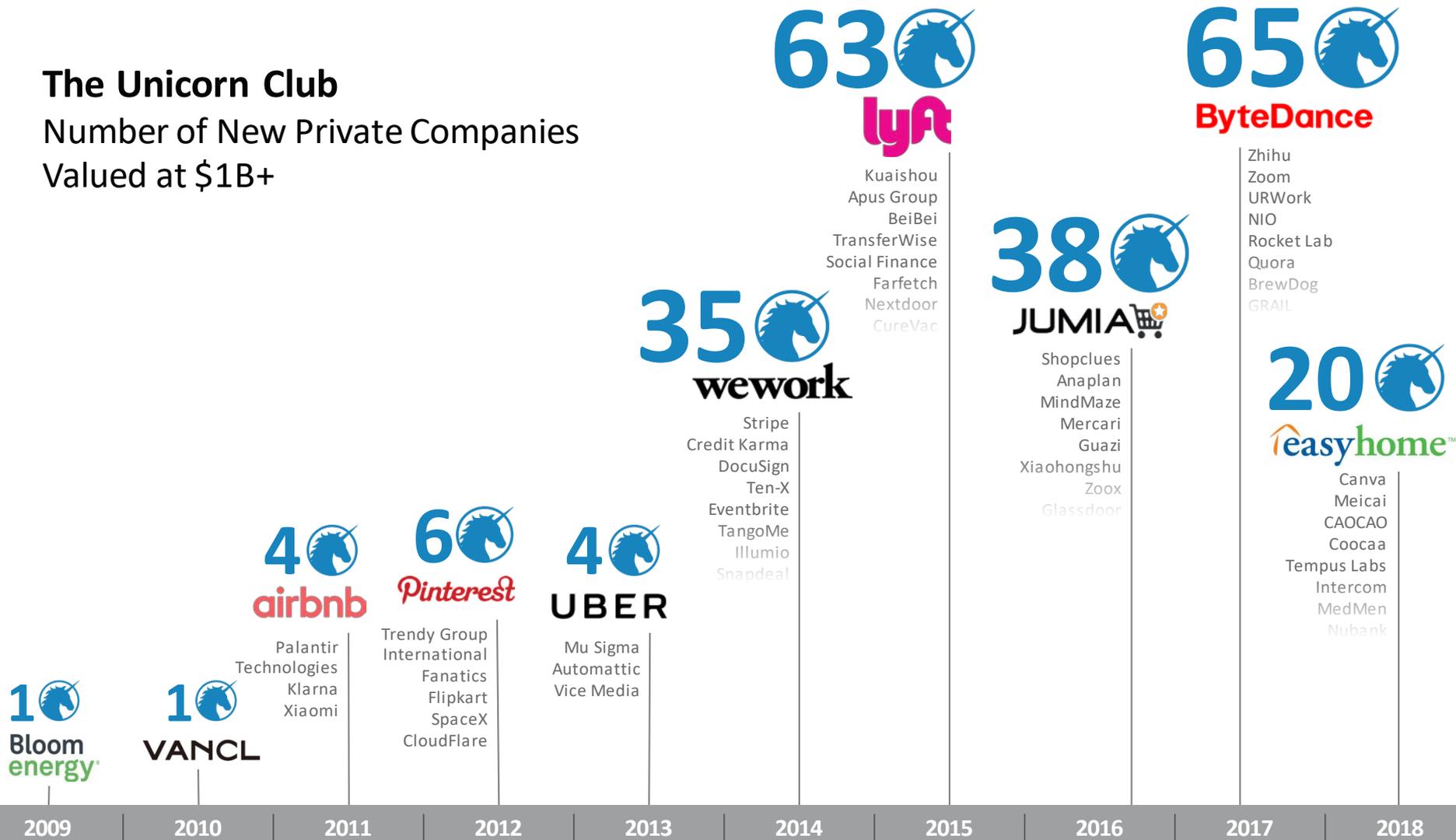


Source: Fortune

I. The Unicorn Landscape

The Unicorn Club

Number of New Private Companies Valued at \$1B+

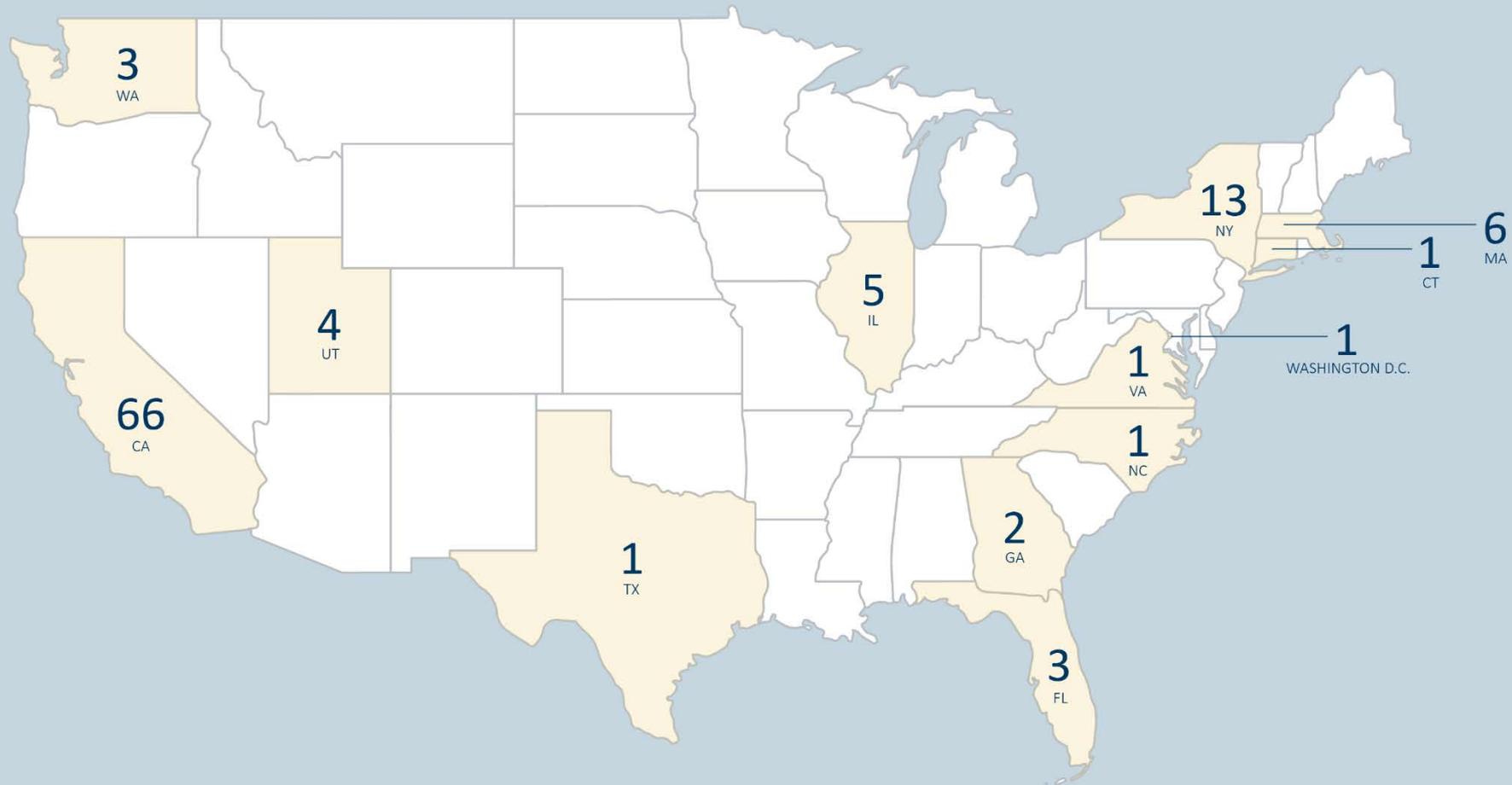


Private Companies Valued at \$1B+ as of 2018 YTD (4/28/2018)

Source: CB Insights Unicorn Tracker (<https://www.cbinsights.com/research-unicorn-companies>)

I. The Unicorn Landscape

US Geographic Dispersion



Private Companies Valued at \$1B+ as of 2018 YTD (4/26/2018)

Source: Dow Jones VentureSource and The Wall Street Journal (<http://graphics.wsj.com/billion-dollar-club/>)

I. The Unicorn Landscape

Global Geographic Dispersion

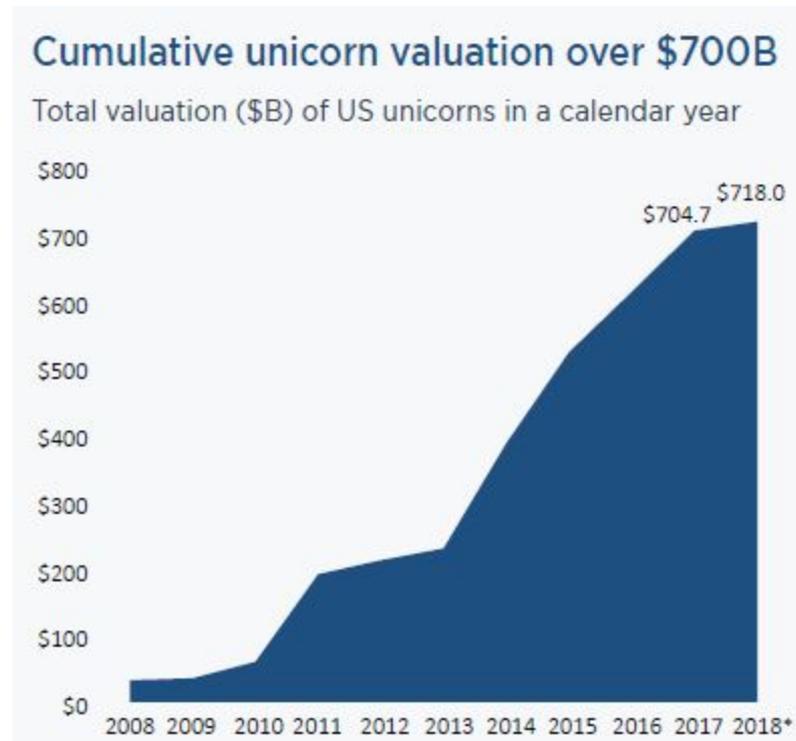


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I. The Unicorn Landscape

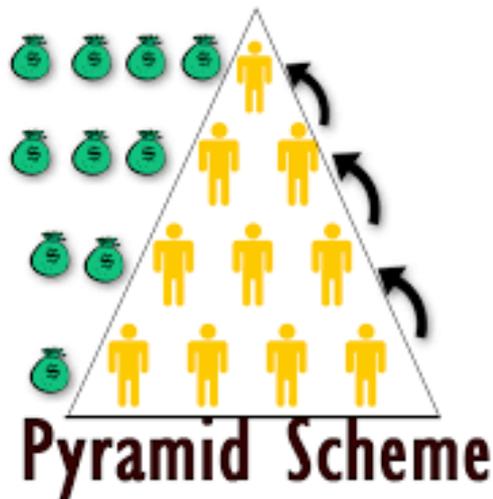
Unicorn Aggregate Valuation (\$Billions) Across Time



*As of 3/1/2018
Source: PitchBook

II. Unicorn Companies: Invincible Against SEC Scrutiny? SEC Historical Actions

- SEC history made up of countless investigations and charges against privately-held companies.
- Historical Anecdote: Ponzi Schemes and Pyramid Schemes



© Can Stock Photo - csp7350212

II. Unicorn Companies: Invincible Against SEC Scrutiny? Remarks of Former SEC Chair Mary Jo White

- “It is axiomatic that all private and public securities transactions, no matter the sophistication of the parties, must be free from fraud. Exchange Act Section 10(b) and Rule 10b-5 apply to all companies and we must be vigorous in ferreting out and punishing wrongdoers wherever they operate. In the unicorn context, there is a worry that the tail may wag the horn, so to speak, on valuation disclosures. The concern is whether the prestige associated with reaching a sky high valuation fast drives companies to try to appear more valuable than they actually are.”
- “[T]he risk of distortion and inaccuracy is amplified because start-up companies, even quite mature ones, often have far less robust internal controls and governance procedures than most public companies. Vigilance by private companies about the accuracy of their financial results and other disclosures is thus especially critical.”

Source: *Remarks of former SEC Chair Mary Jo White, SEC-Rock Center on Corporate Governance Silicon Valley Initiative, March 31, 2016* (<https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html>).

II. Unicorn Companies: Invincible Against SEC Scrutiny? Jay Clayton Speech

- Jay Clayton, Addressing House of Representatives Financial Services Committee in Washington D.C., October 4, 2017:
 - “[With] the Jumpstart Our Business Startups (JOBS) Act, there is an ecosystem displaying that a scaled disclosure and regulatory system provides incentives for companies to conduct public offerings while maintaining the world’s most robust investor protections. To be clear, this does not mean that we would sacrifice or limit the core principles of our public disclosure regime and other essential investor protections for the sake of accelerating public issuances.”
 - Source: *Chairman Jay Clayton’s Testimony Before the U.S. House of Representatives Committee on Financial Services, October 4, 2017*
(<https://www.sec.gov/news/testimony/testimony-examining-secs-agenda-operation-and-budget>).

II. Unicorn Companies: Invincible Against SEC Scrutiny? Jurisdictional “Hooks” for the SEC

Anti-Fraud Provisions

- Section 17(a) of the Securities Act of 1933
 - Unlawful for any person in the offer or sale of **any securities**...: (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or omission of material fact, or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.
- Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934
 - Unlawful for any person... (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or omission of material fact, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
 - In connection with the purchase or sale of **any security**.

II. Unicorn Companies: Invincible Against SEC Scrutiny? Jurisdictional “Hooks” for the SEC

- How can anti-fraud provisions be a regulatory hook for the SEC to reach unicorn companies?
- Privately-held companies can still be charged for:
 - Untrue statements that are material to investors
 - Schemes to defraud
 - Omitting to state material facts necessary to make stated facts not misleading
- For SEC to use anti-fraud provisions, misstatements, omissions, and schemes to defraud have to be made *in connection with* the:
 - offer,
 - sale, or
 - purchase of securities.

II. Unicorn Companies: Invincible Against SEC Scrutiny? Current Issues Facing Unicorns



Bribery Allegations



Investor Skepticism



Data Breaches



Regulatory Challenges



*Discriminatory Hiring Practices &
Sexual Harassment*



Toxic Corporate Culture



Employee/Contractor Rights



Unfair Business Practices

Based on news articles obtained via internet research for the top 25 U.S. Unicorns for the period from Oct 2014 to Apr 2018.

II. Unicorn Companies: Invincible Against SEC Scrutiny? Social Backlash

- Are companies required to disclose issues that are not related to securities but could cause social backlash?
- Distinction between privately-held companies and publicly-traded companies
 - Management Discussion & Analysis (MD&A) requirements
 - Anti-fraud provisions of the securities laws apply to both public and private companies
 - Is failure to disclose the information misleading or a material omission?
- Also consider whether a fiduciary duty requiring disclosure obligates the company to update or speak

II. Unicorn Companies: Invincible Against SEC Scrutiny? Public Company Example – Altaba (formerly Yahoo)

- On April 24, 2018, it was announced that Altaba, the holding company that contains the remnants of Yahoo, agreed to pay a \$35 million SEC penalty to settle charges relating to its handling of Yahoo's well-publicized 2014 data breach.
- The SEC alleged that Yahoo failed to disclose to investors its knowledge of a massive data breach that exposed the personal data of hundreds of millions of users.
- This data breach has also exposed Yahoo to liability in other civil actions.

TECH

Yahoo's Successor to Pay \$35 Million in Settlement Over Cyberbreach

Regulators, in a first, penalize public company that was the victim of a hack



The SEC said the company, now known as Altaba, failed to properly investigate the 2014 breach and weigh whether it should be disclosed to shareholders. PHOTO: VICTOR J. BLUE/BLOOMBERG NEWS

By Dave Michaels

Updated April 24, 2018 3:58 p.m. ET

Source: The Wall Street Journal

II. Unicorn Companies: Invincible Against SEC Scrutiny? Selected Examples



THE WEINSTEIN COMPANY



II. Unicorn Companies: Invincible Against SEC Scrutiny? Selected Examples

- 21st Century Fox was embroiled in litigation stemming from reports of sexual harassment and gender and racial discrimination at Fox News Channel.
- CEO of Social Finance (SoFi) – the online personal finance unicorn – resigned in the wake of sexual harassment allegations.
- In the wake of numerous allegations of sexual abuse and misconduct levied against Harvey Weinstein in the fall of last year, the Weinstein Company declared bankruptcy and has recently declared a private equity firm, Lantern Capital Partners, as the winning bidder in its bankruptcy sale. This sale must be approved by a bankruptcy judge and could be challenged by creditors.
- And Wynn Resorts has been fighting shareholder derivative actions alleging that the Company's officials and board members turned a blind eye towards the alleged misconduct of former CEO Steve Wynn.

II. Unicorn Companies: Invincible Against SEC Scrutiny? Rule 701 “Hooks” for the SEC

credit karma



Rule 701 of the Securities Act of 1933 (Compensation Agreements)

- Rule 701 exempts from the registration requirements of Section 5 of the Securities Act, offers and sales of securities issued to employees, or other persons providing services to the company, pursuant to a written employee compensation plan established by the issuer or related parent companies.
- Rule 701 thus provides an exemption which allows privately-held companies to give out stock options in the company to employees or other service providers without registering these securities with the SEC.
- However, Rule 701 has conditions and restrictions that impact the amount of securities a company can sell and the disclosures that must accompany the securities issued under this rule.

II. Unicorn Companies: Invincible Against SEC Scrutiny? Recent SEC Actions Against Private Corporations

- The SEC's San Francisco Regional Office has charged three private corporations in the current fiscal year: Zenefits, Credit Karma, and Theranos.
- In commenting on the Commission's charges against Theranos, Steven Peikin, the Co-Director of the SEC's Enforcement Division, emphasized: "[T]here is no exemption from the anti-fraud provisions of the federal securities laws simply because a company is non-public, development-stage, or the subject of exuberant media attention."

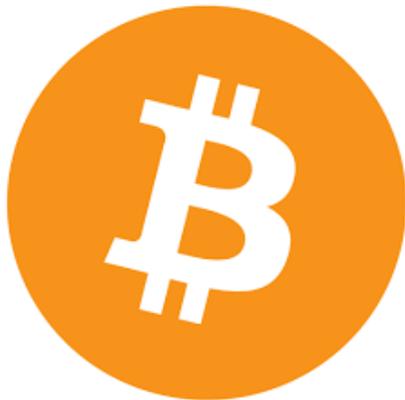
credit karma

zenefits



II. Unicorn Companies: Invincible Against SEC Scrutiny? Coin Offerings as a Fundraising Mechanism

- What are ICOs?
- Does using coin offerings for fundraising impact the likelihood of SEC interest?



II. Unicorn Companies: Invincible Against SEC Scrutiny? Coin Offerings as a Fundraising Mechanism

- In the United States, no single agency is responsible for federal oversight of virtual currencies, so U.S. regulation has evolved into a multi-regulatory approach involving:
 - SEC
 - CFTC
 - FTC
 - State-by-state regulation



II. Unicorn Companies: Invincible Against SEC Scrutiny? Coin Offerings as a Fundraising Mechanism

- The SEC has suggested, though not confirmed, that it views most digital tokens and ICOs as securities, and thus subject to securities laws.
- As Chairman Clayton has explained: “To the extent that digital assets like ICOs [initial coin offerings] are securities—and I believe every ICO I’ve seen is a security—***we have jurisdiction and our federal securities laws apply.***”
 - Source: *SEC Says Releasing Tezos Documents Could Hurt Enforcement Activities*, February 9, 2018 (<https://www.reuters.com/article/us-bitcoin-tezos/sec-says-releasing-tezos-documents-could-hurt-enforcement-activities-idUSKBN1FT2V1>).

II. Unicorn Companies: Invincible Against SEC Scrutiny? Coin Offerings as a Fundraising Mechanism

- In SEC v. W.J. Howey Co., 328 U.S. 293 (1946), the U.S. Supreme Court established a test for whether an asset constitutes an investment contract and thus can be classified as a security.
- Investors and corporations should expect the SEC to apply the Supreme Court's Howey test to ICOs.
- Howey factors:
 - Investment of money
 - Held in a common enterprise
 - With an expectation of profit
 - Solely from the efforts of others

II. Unicorn Companies: Invincible Against SEC Scrutiny? Coin Offerings as a Fundraising Mechanism

- The Howey test in action:
 - On July 25, 2017, the SEC issued a Section 21(a) Report considering the offer and sale of tokens by a virtual “Decentralized Autonomous Organization” (“The DAO”), which were offered and sold in exchange for Ether, a virtual currency.
 - The Commission considered the Howey test and concluded that DAO tokens were securities and thus subject to federal securities laws.
 - Sources: *SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities*, July 25, 2017 (<https://www.sec.gov/news/press-release/2017-131>); *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, July 25, 2017 (<https://www.sec.gov/litigation/investreport/34-81207.pdf>).

The
Economist

Crypto-investing
The DAO of accrue

A new, automated investment fund has attracted stacks of digital money



Print edition | Finance and economics >

May 19th 2016

IT SOUNDS like a cult, but it wants to be a venture-capital fund of sorts. As *The Economist* went to press, the DAO (short for decentralised autonomous organisation) had already raised the equivalent of nearly \$150m to invest in startups. This, say its fans, makes it the biggest crowdfunding effort ever.

Source: The Economist

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II. Unicorn Companies: Invincible Against SEC Scrutiny? Coin Offerings as a Fundraising Mechanism

- Though the SEC has not formally adopted this stance, note that cryptocurrencies generated through the efforts of investors (e.g., by mining) may be distinguishable under Howey.
- “In analyzing whether something is a security, ‘form should be disregarded for substance,’ ... ‘and the emphasis should be on economic realities underlying a transaction, and not on the name appended thereto.’”
 - Source: *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, July 25, 2017 (<https://www.sec.gov/litigation/investreport/34-81207.pdf>).
- Highly-decentralized cryptocurrencies, including Bitcoin, that do not have a third-party promoter may also be distinguishable.

The New York Times



A Former Top Wall Street Regulator Turns to the Blockchain



Gary Gensler, a senior lecturer at the M.I.T. Sloan School of Management, at the M.I.T. Media Lab. Mr. Gensler, once one of the top financial regulators in the Obama administration, will teach a class on the blockchain in the fall. Kayana Szymczak for The New York Times

By Nathaniel Popper

April 22, 2018

SAN FRANCISCO — Gary Gensler was one of the top financial regulators in the Obama administration, the finance chief for Hillary Clinton’s 2016 presidential campaign and, before both of those jobs, a partner at Goldman Sachs.

Source: The New York Times

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II. Unicorn Companies: Invincible Against SEC Scrutiny? Coin Offerings as a Fundraising Mechanism

- Speaking on virtual currencies Ether and Ripple, Gary Gensler, former Chairman of the Commodity Futures Trading Commission, has recently stated: “There is a strong case for both of them — but particularly Ripple — that they are noncompliant securities.”



- But Mr. Gensler believes that Bitcoin can remain exempt from securities regulations.
 - Source: *A Former Top Wall Street Regulator Turns to the Blockchain*, April 22, 2018 (<https://www.nytimes.com/2018/04/22/technology/gensler-mit-blockchain.html>).



II. Unicorn Companies: Invincible Against SEC Scrutiny? Coin Offerings as a Fundraising Mechanism

- The SEC has reportedly subpoenaed or issued voluntary requests for information to more than 200 cryptocurrency companies and individuals as part of a crackdown on unregistered securities offerings and potential fraud.
- The SEC has likewise instituted numerous enforcement actions involving ICOs.
 - PlexCorps
 - Munchee
 - Montroll
 - AriseBank
 - Centra Tech, Inc.
- The SEC has suspended trading in several cryptocurrency-related enterprises
 - HD View 360 Inc.
 - PDX Partners Inc.
 - UBI Blockchain Internet Ltd.

II. Unicorn Companies: Invincible Against SEC Scrutiny? Coin Offerings as a Fundraising Mechanism

Can the SEC interest you in some HoweyCoins?

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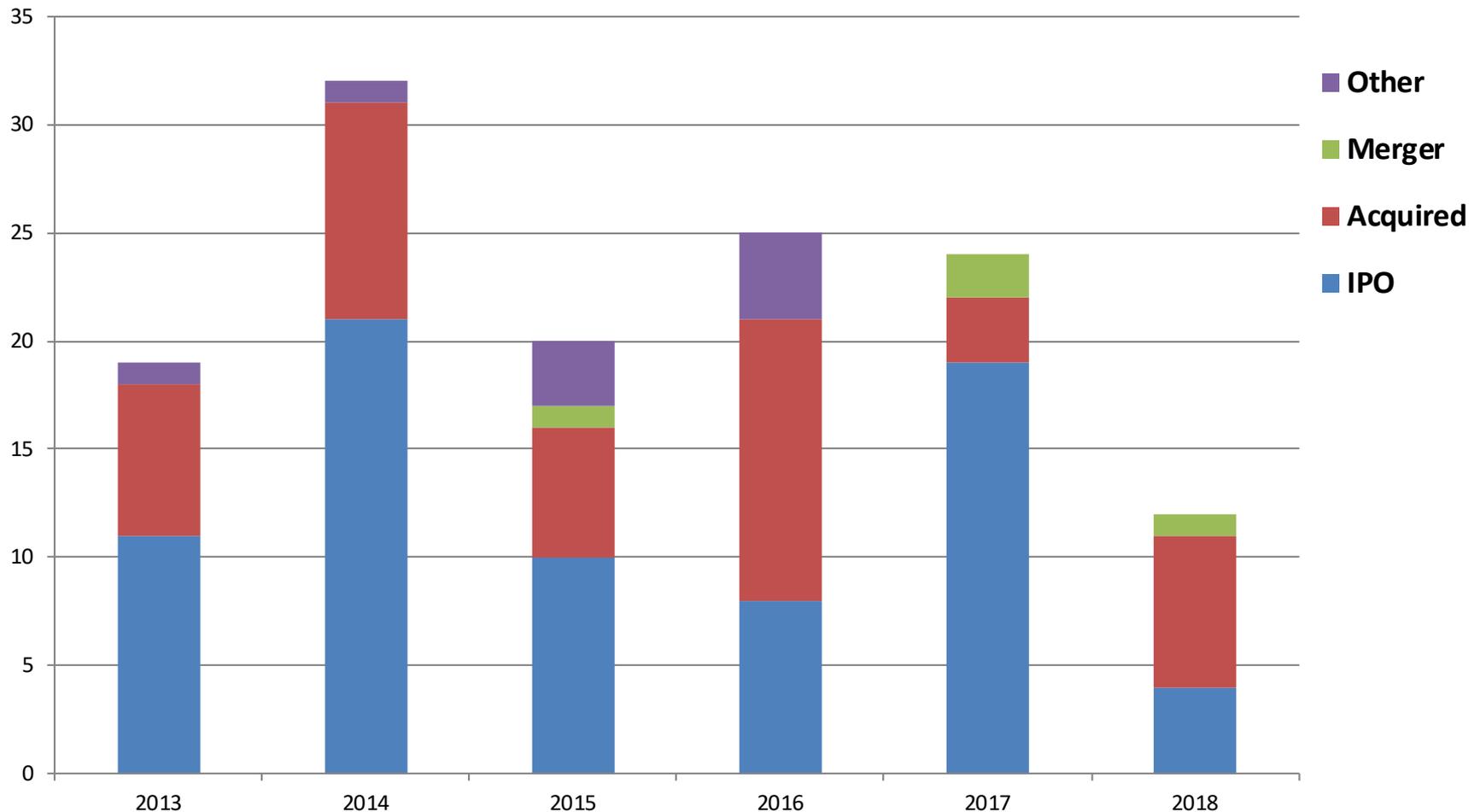
II. Unicorn Companies: Invincible Against SEC Scrutiny? Coin Offerings as a Fundraising Mechanism

- In addition to potential SEC oversight and actions, digital tokens may be subject to oversight from other federal regulators.
- Digital tokens can also be considered commodities.
- The definition of “commodity” in the Commodity Exchange Act is broad, and includes:
 - A physical commodity, as well as
 - “[A]ll services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in.”

II. Unicorn Companies: Invincible Against SEC Scrutiny? Coin Offerings as a Fundraising Mechanism

- According to a March 2018 ruling by Federal Judge Jack Weinstein, the CFTC has “broad leeway” to interpret the federal law regulating commodities.
 - Sources: *U.S. Commodity Futures Trading Commission Press Release 7702-18*, March 6, 2018 (<https://www.cftc.gov/PressRoom/PressReleases/pr7702-18>); *Virtual Currencies Are Commodities, U.S. Judge Rules*, March 6, 2018 (<https://www.reuters.com/article/us-usa-cftc-bitcoin/virtual-currencies-are-commodities-u-s-judge-rules-idUSKCN1GI32C>).
- Judge Weinstein ruled that the CFTC had standing to bring a fraud lawsuit against a New York resident and his company, Coin Drop Markets.
 - The CFTC won a preliminary injunction against defendants.

III. Transitioning From Private to Public Unicorn Exits



Source: CB Insights Unicorn Exits Tracker (<https://www.cbinsights.com/research-unicorn-exits>)

2018 reflects the number of Unicorn exits through 4/26/2018.

III. Transitioning From Private to Public Preparing to Go Public

- Issues unicorn management should be focused on from an SEC/securities regulation standpoint
- Timing considerations
- Confidentiality & draft registration statements

III. Transitioning From Private to Public Gone Public – What Now

- Common pitfalls
- How to avoid them



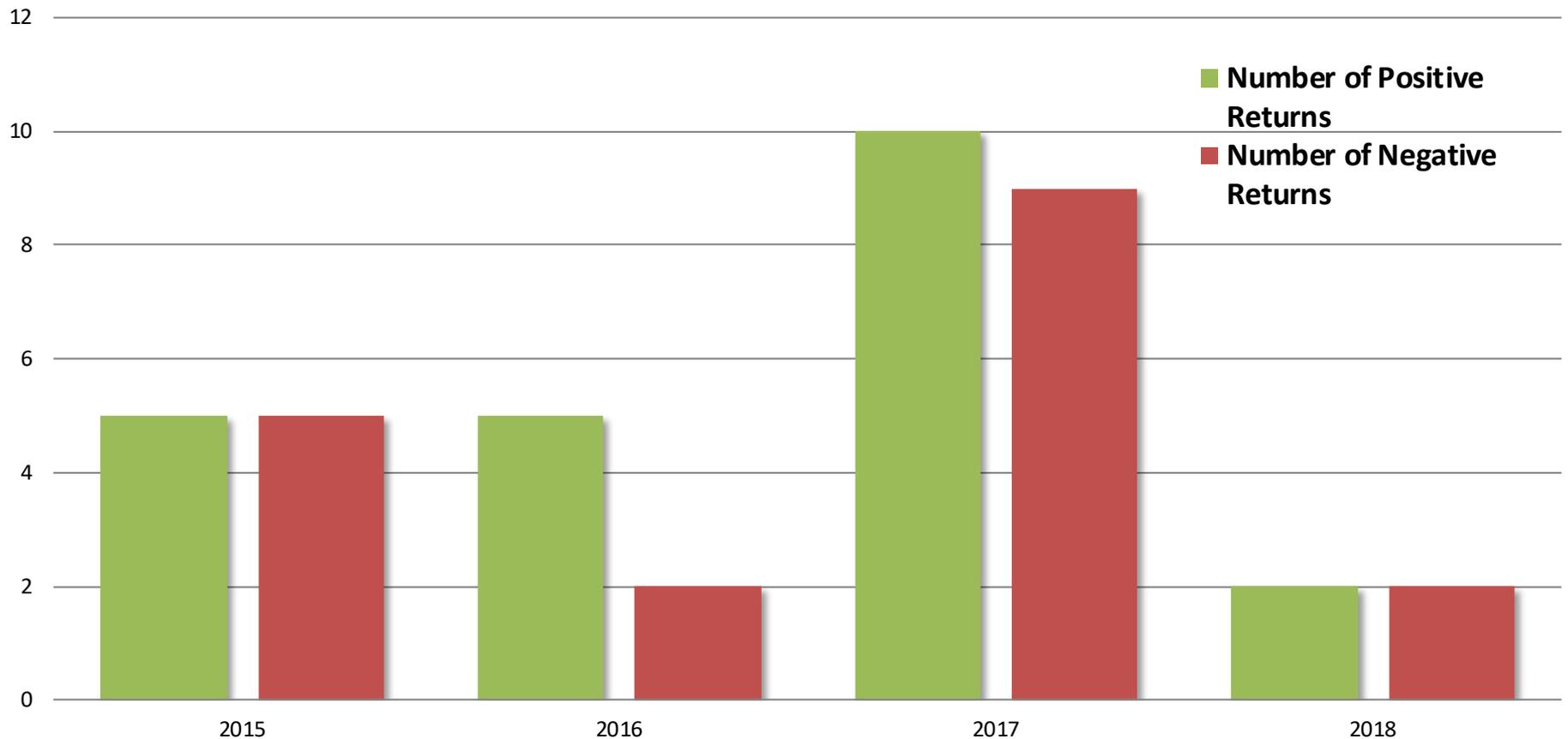
Forbes 
@Forbes

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The IPO class of 2018: Spotify, Dropbox and other unicorns take center stage
on.forbes.com/6019DKIQx

III. Transitioning From Private to Public

Unicorn Exits via IPO – Cumulative Positive / Negative Returns



Notes/Sources: Pricing data for Ucar Group (exited via IPO 7/22/2016) was not available and has been excluded from this analysis. Return was based on the change between the Unicorn's opening morning IPO price and the closing price on April 25, 2018. Exit Data per CB Insights (see <https://www.cbinsights.com/research-unicorn-exits>); Pricing data per Bloomberg Terminal.

III. Transitioning From Private to Public Gone Public – What Now

- Subsequent drops in stock price
- When the SEC comes knocking at your door



Greg Fox @gregwfox · Apr 25

Two of the biggest start-ups still sitting on the sidelines in 2018: #Dropbox and #Spotify, successfully went public over the past month, and #siliconvalley #VC firms are preparing for a massive #ipo wave over the coming months.

IV. Trump Administration: Current SEC Environment Attraction of US Public Markets

- The SEC under the new administration seems to be trying to discourage companies from staying private for as long as they have in recent history:
 - The Securities and Exchange Commission, in Jay Clayton’s first major policy move as chairman, announced it would allow all private companies to keep some details of their finances and business strategies under wraps early in the process of an initial public offering.
 - The commission said [in June] that permitting all companies to file secretly would give them more flexibility to plan their offerings and reduce “the potential for lengthy exposure to market fluctuations that can adversely affect the offering process and harm existing public shareholders.”
 - Source: *SEC's Division of Corporation Finance Expands Popular JOBS Act Benefit to All Companies*, June 29, 2017 (<https://www.sec.gov/news/press-release/2017-121>).

IV. Trump Administration: Current SEC Environment Attraction of US Public Markets

- Pushing for more companies to form in the U.S.
 - SEC Advisory Committee on Small and Emerging Companies
 - SEC Launches Nationwide Search to Hire Agency's First-Ever "Advocate for Small Business Capital Formation" (September 13, 2017)
 - Source: *SEC Launches Nationwide Search to Hire Agency's First-Ever "Advocate for Small Business Capital Formation"*, September 13, 2017 (<https://www.sec.gov/news/public-statement/commission-public-statement-9-13-17>).

IV. Trump Administration: Current SEC Environment Enforcement Priorities

- “Mr. Clayton stressed that protecting the interests of ‘Main Street’ investors would be a fundamental principle underlying the SEC’s efforts to fulfill its three-part mission of protecting investors, maintaining fair and orderly markets, and facilitating capital formation.”
 - Source: *SEC Chairman Clayton Outlines Priorities, Signals Focus on Disclosure Requirements*, July 26, 2017 (<http://www.jdsupra.com/legalnews/sec-chairman-clayton-outlines-24290/>).
- “Mr. Clayton told the senators that ‘there is zero room for bad actors in our capital markets.’”
- But Mr. Clayton has signaled that the SEC may consider the costs to shareholders in imposing penalties on companies, as “shareholders do bear those costs and we have to keep that in mind.”
- Mr. Clayton has noted that greater deterrence was possible by pursuing individuals rather than seeking large payments from corporate violators.
 - Source: *What the Future of SEC Enforcement Holds Under Jay Clayton*, March 27, 2017 (<https://www.nytimes.com/2017/03/27/business/dealbook/sec-chairman-jay-clayton.html?mcubz=3>).

V. Takeaways

- The current administration will look for opportunities to encourage IPOs and unicorn exits from private to public.
- Will remain aggressive about provably false statements luring investments of capital into privately-held companies, even if prestigious company or product.
 - Especially true where product is not as represented, or is entirely false.
- Fewer technical violations that can be charged against privately-held companies since they are not registered.
 - Current administration unlikely to pursue technical issues as aggressively.

VI. Questions?

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