How to Raise Capital in the New Digital Private Markets - DRAFT

A Company Handbook, Published by Global Digital Finance

30 July 2020

Anthony Woolley

Ami Ben David

GLOBAL DIGITAL FINANCE

Introduction & Management Summary

In the wake of the Covid-19 crisis, the world's leading financial institutions, including banks, asset managers, exchanges and technology players, are coming together, to take private markets online via a global digital network, interconnecting their institutional investor base.

This document details how your PRIVATE company can raise capital and enable liquidity of its equity, by creating a new tradable DIGITAL SHARES CLASS on your existing cap table, to be issued and traded on this global network.

Background

In 2019 alone, $894 billion of new capital flowed into private companies and assets. Global private equity net asset value grew 7.5 times this century, twice as fast as public market capitalisation (but with 330X LESS liquidity for shareholders), as investors look for exposure and diversified participation in global growth. At the same time, Private Equity dry powder, or uncalled capital, hit a record high of $2.5 trillion looking for allocation.

Covid-19 completely changed the landscape almost overnight.

The first priority of governments going into the Covid crisis was (rightly) the preservation of life, at the expense of the economy. Going out of the crisis will be about the economy.

Private companies need capital, but the model for raising that capital is slow, manual, costly, inefficient, and based on personal introduction networks and face to face meetings. **The "new normal" means these old processes must go digital.** It's an opportunity to reinvent the way private companies raise capital - and the financial market is responding.

Call to Action

In May 2020, a financial industry group, the Private Markets Digitization Steering Group, was formed under the umbrella of GDF to address the challenge posed by the Covid crisis. The group includes **dozens of the biggest financial institutions, market infrastructure players, major technology companies, Fintech startups and regulation experts**.

The group is working together towards the initial launch of a global institutional network to digitize private markets within 6-12 months, with a phase 1 specifically focused on helping private companies raise capital online efficiently using digital shares, in an effort to help the companies and the economy out of the crisis.

What does it mean for the executives and shareholders of a private company?

Unlike public markets, the management and trade of private shares has remained largely manual and local, and has not gone through digitization, systematization or automation. We therefore live in a binary world: either a company is big enough to go public, so it can work with the top financial institutions, market freely to millions of investors, and enjoy liquidity. OR, it is private, and would typically only raise capital via personal networks of investors, pitching to an average of 30-50 investors per round, and offering near zero liquidity (sometimes for many years, sometimes forever) to founders, management and early investors.

Until now, there was nothing in between Public and Private.

The digitization of equity will turn the market from binary to **elastic** by allowing private companies to remain private, while creating a new class of tradable digital shares on their cap table, which can be issued and traded online in the institutional marketplace.

Those tradable digital shares will allow private companies to join a global distribution network of financial institutions such as banks, asset managers and exchanges, which can put these companies in front of hundreds of thousands of accredited and institutional investors (= the clients of these financial institutions), from all over the world.

In terms of liquidity potential, It will also allow a company to let current shareholders convert non-digital shares to the tradable digital shares at its discretion, thereby enabling the frictionless trade of those digital shares within the institutional network, and in compliance with all regulations.

A private company CEO, C-suite and shareholders reading this handbook, will gain a clear view of the path to launching a digital shares class in their cap table, and the opportunities it opens for both raising new capital in the institutional market, and for tradability of their equity in the company.

The Private Markets in 2020

The world before COVID-19

At the start of the Covid-19 crisis, the Private Equity market had just completed its strongest six-year stretch in history with $3.2 trillion[1] in disclosed deal value. In 2019 alone, total private capital investment, including private equity and VC, real estate, infrastructure and natural resources topped $894 billion. At the same time, Private Equity dry powder, or uncalled capital, hit a record high of $2.5 trillion. Two-thirds of this was raised in the last two years. Therefore, the capital aimed at private companies is there. And we need a scalable online network optimized to match the right investors to the right companies in the post COVID-19 reality.

Impact on the Private Markets

Nobody really knows what the impact of Covid will be on the Private Markets. Looking at past economic shocks it is likely that there will be a short-term retreat from the recent period of high growth. Investors are currently focused on triaging clients and portfolios. However funds will not leave that uncalled capital unallocated for long.

One quality that both investors and private companies have in common is their ability to adapt to changing circumstances with an agility that larger companies and listed funds lack. Certainly we face a unique set of circumstances. On a macro level we have entered a global economic crisis and many economies may slide from recession into depression. Against this backdrop investors are hoarding cash whilst private companies are adapting to the new reality and looking for financing to capitalise on new opportunities.

A Recipe for Disruption - Why now?

Who led the digital transformation of your company?

A) CEO
B) CTO
C) COVID-19 ✓

This was a popular meme that circulated on twitter early in the pandemic. It was popular because it also held a certain truth. The current crisis has accelerated digital adoption through necessity. However that transformation is now being sustained through an irreversible cultural change as society adapts to new ways of working in a virtual world.

---

[1] Bain & Company’s 11th annual Global Private Equity Report

We now understand that meetings can be held on line; that commuting is often unproductive and international travel is inefficient. Indeed many have discovered the benefits of the Zoom Effect - that virtual working facilitates collaboration between global parties that may not have met before the crisis; that new introductions are easier to arrange on a video call and that reliance on physical meetings limits business opportunities to local environments and cultures.

These benefits are equally applicable to the process of raising capital. Why should investors only come from a limited personal contact network? Why embark on expensive investor roadshows when those can be taken online? Why go public when a global private markets network can target the types of investors you are looking for in a much more efficient way?

The Vision of Digital Securities

Over the last five years the blockchain technology that was made famous by bitcoin has been adapted to meet the needs of new applications in various industry sectors. Arguably one of the most transformational of these will be digital securities. Digital Securities, as the name suggests, are digital representations of conventional financial securities, subject to traditional securities laws and regulations but in digital form.

The benefits of digital securities are immense. They can represent all types of assets including equity, debt, investment contracts and even a fractionalized interest in a physical asset such as a hotel or a wind farm.

The foundation of a digital securities network is a blockchain, or distributed ledger technology (DLT) network, that can track, audit and assert the record of ownership of assets through an immutable ledger that cannot be tampered with. Such a network can automate a share registry; ensure regulatory compliance across multiple jurisdictions and manage the lifecycle of an ownership from primary raise and custody through to secondary trading, clearing and settlement. Where a process cannot be fully automated, it can be systematized so increasing efficiency and driving down costs.

What Exactly are Digital Shares?

All private companies must manage a “shareholders register”, usually in the form of a cap table. This cap table can be managed on a spreadsheet with accompanying legal documents, or using cap table management service providers. Issuance and trade of private shares (as well as payment and settlement and updating the cap table) is today done mostly manually.

The **Digital shares defined in this document, simply replace the cap table spreadsheet with a digital ledger** managed across a group of trusted financial institutions (Institutional-grade DLT). The immediate advantages are:

- The ability for banks, asset managers and exchanges to offer a simple **online** interface to investors, where they can find and research private companies, make investment decisions, and execute them online.
- Instant settlement (i.e. seconds after a transaction, the cap table is updated, the new owners own the shares, and the company or seller has the money in their account). Those investments will then show on the dashboards of investors, potentially alongside their other investments, such as their public shares holdings.
- Global transactions become frictionless, because all regulatory compliance is automated - so private capital raises are international by design. Moreover, a digital share register with one institution can technically (subject to regulation and distribution decisions) be traded by the clients of any other institution on the network (without the need for dual listing facilities and T+2 settlement periods).
- Secondary trading becomes as frictionless as public shares trading - but only for those investors who are allowed to participate in private offerings (typically accredited investors, funds, institutional investors etc).
- The company may have full control over factors such as what types of investors may see the offering (i..e "only funds or family offices above a certain size"), what rights they want to grant holders (for example, digital shares may not have full voting rights), they may set restrictions on certain countries and so on.

A simple to implement model for a private company - the digital shares class

Recognizing that companies already have an existing cap table, a useful model for a company with existing shareholders holding various rights and provisions, would be **to create a new, digital shares class** in its current cap table.

- Current holders will continue to hold their standard shares with all their rights.
- The new tradable digital shares class will have **no trading restrictions** (such as Right of First Refusal).
- It may also have **less control rights** (such as no veto-rights) to make sure the company can remain agile.

This class will therefore have the disadvantage of having less investor protections, but the advantages of being instantly tradable (within regulations - usually to accredited investors, funds and institutional investors).

The company will then have the opportunity to also offer its **existing shareholders** to convert part of their holdings into the new digital share class. It can decide how much each holder group can convert (i.e. "Founders can only convert X% of their holdings per year"), and at what conversion price. Once converted, the digital portion of the holdings will immediately be tradable.

The Global Institutional Digital Securities Network

Going into the crisis the financial ecosystem was already in the process of evaluating digital solutions for private securities - but did not have a plan for an interconnected global institutional marketplace. Sometimes, a crisis is a catalyst to change, and with this initiative, the financial industry is taking the opportunity to look at creating an interconnected network where every financial institution (such as the banks, asset managers and exchanges in the GDF steering group) can seamlessly connect their clients to the same multi-DLT network, defined by the group under the name FinP2P.

Distribution IS key. Therefore, this network is designed so that when a company's digital shares class goes online, every institutional investor connected to this network, from around the globe (within regulation and the company's distribution decisions) may be able to see and transact the shares online, potentially putting the company in front of hundreds of thousands of relevant investors.

At the end of each relevant chapter, this handbook details what a company needs to do to get on the network, raise capital, and enable secondary trade.

Private Capital Markets - Digitizing the Market

The main issues with the current model for raising capital for private companies fall into 6 buckets. In each of the buckets, we will define the pain, the cure, and what are the steps a company needs to take when onboarding onto the network.

No standards for online due diligence and information requirements.	No network effect, 30-50 investors pitched per round via personal connections.	Complex, costly, non-standard legal docs, with a fight over every clause.
Manual and inefficient management of investors and transactions.	Near zero liquidity potential for years for founders, employees and investors.	No business model for financial institutions to bring their investors at scale

A sample network use case

The market was accustomed to working in a certain way for decades, so to paint a clearer picture and demonstrate the target of the network, it may be useful to look at a simple use case. This use case demonstrates a scenario of how the network would bring value to a fictional space exploration company looking to raise new capital.

BlueSky Raising Capital through Bank US

- BlueSky Space, a private company, wants to raise capital.
- Bob, BlueSky's CEO, agrees with his investment bank, BankUS to distribute the company on the digital network.
- Bob creates a new tradable digital shares class on his cap table.
- BankUS:
    - Registers BlueSky digital shares on the network, and uploads its KYA (Know your Asset) documents, such as a placement memorandum.
    - BankUS sets up the regulatory requirements for the raise (Reg D 506c).
    - BankUS authorizes other banks on the network to participate in the round, and specifies the types of suitable investors, and a minimum ticket size.

BR Capital Investing through Bank UK

- BR Capital is a client of BankUK.
- Alice, Managing Partner of BR Capital, logs into her BankUK dashboard looking for Space sector opportunities, where she finds and explores BlueSky.
- Alice decides to invest $10m in BlueSky, and makes the investment:
  - Transaction is verified by BankUS's node for compliance.
  - Transaction **settles instantly**.
- Alice now has $10m in BlueSky shares on her BankUK dashboard.

BlueSky Receives the Capital

- BlueSky's CEO, Bob, receives a notification, and opens his BankUS mobile app.
- He can see the updated cap table, including BR Capital's shares, value of $10m.
- His bank account now shows an additional $10m (minus fees).

As described in this simplified use case, the network tackles the 6 pain buckets.

1. Due Diligence and information.

Standardized online due diligence materials and structured data.

The Pain:

Unlike in the public markets, there are no specific legal requirements or standards for what information companies should provide to investors. Every company creates its own materials in a different way, provides different documents for due diligence, and relies mostly on face to face presentations to tell a story. This is slow, inefficient as each investor often asks for more information separately, and not conducive to creating an efficient market..

Moreover, company data is not structured in any global repository, so it's hard to automate and scale the matching process and allow institutional investors to identify the companies that may match their investment criteria across global markets.

An even bigger problem, is that in private markets, due diligence materials are only available for primary capital raises, but then, (unlike in secondary public markets), companies have no official disclosure and update requirements, which is one of the key reasons there is no vibrant secondary private market trade (more on that below).

The Cure:

Standardisation: We would be looking to publish over time the basic requirements from a private company going onto the network. The must-have and the nice-to-have in a company's private raise documents. These documents will be referred to as the asset's KYA (Know your Asset) documents.

Harmonisation: We will also enable companies to provide Structured Data to the network, so that potential investors can scan and search the market more efficiently at scale. In addition, in future, structured data will enable the creation of indexes, buckets and derivatives, which may add liquidity to smaller companies.

Reputation: Each asset will be brought onto the network by ONE financial institution. This institution will be known as the asset's Primary node. An institution's reputation on the network will be dependent on the quality of the companies they bring to market, which will incentivize them to help the companies deliver better documentation, information and raise marketing materials.

Secondary market: We are looking for self-governed industry standards, which are not too onerous on the companies (like the requirements from public companies), but are enough to provide the data required for potential secondary investors. This balance has to be discussed, and may vary across asset classes and life cycle stages, and there are some examples and best practices in the market.

Tasks for company joining the network:

1. Arrange with a financial institution to take you online on the network.

2. Create a document describing the company to investors, such as a Private Placement Memorandum (templates will be made available).

2. Network Effect - Reaching a Global Investor Base

A global network, hundreds of thousands of potential institutional investors.

The Pain:

The current model for meeting investors in the private market is based on **personal relationships networks**. These networks tend to be localized, limited, dependent on "who the CEO knows directly or via one hop", and therefore suffer from inefficiencies and biases.

The very large companies can go public and meet **millions** of investors. The very small companies can go crowdfunding and meet **thousands** of investors. But the vast majority of private companies approach investors directly. A typical raise takes 3-6 months, in which management would pitch 30-50 investors. The mirror view is that only 50 investors (out of potentially thousands of suitable investors globally) get exposure to the company.

In addition, the current model favours specific types of companies - for example many VCs are interested only in companies that fit their business model based on long haul meteoric exits. Companies that fit that specific model would do extremely well also on the network and may fund faster, or on better terms. But this VC model also puts many great but different profile companies at a disadvantage and even forces founders to a course they may not like - where given a more efficient global market, they would easily find investors more suitable for the size, frequency, funding goals, and type of rounds they prefer and the risk/reward profile they offer.

It's not that the current model doesn't work - companies obviously do raise capital and the pre-Covid-19 market was growing, but the market as a whole is **inefficient**, **not optimized** and reaching its **scalability limitations** (especially during an economic crisis) as much more capital is looking for private allocation.

The institutional financial industry is currently playing only a small part in this market (see business model pain below), but it now has the opportunity to bring true efficiency and scale through a much more **elastic** market - where the exposure and distribution a company gets will correlate to its core parameters, potential, and risk profile.

The Cure:

Distribution: A global institutional network, on which a private company will have the ability to present online to every suitable institutional investor across the network (within regulations and distribution decisions), and every institutional investor will have the opportunity and tools to find that company assuming it falls within their investment criteria.

Zero friction: Investors will invest in the digital shares class, transactions will settle instantly, and investors will be granted standard digital shareholder rights as defined in the KYA legal documents of the company.

Flexibility and control: giving companies the flexibility and choice in how they want to raise, for what purposes, who from, when, and what terms to offer.

Tasks for company joining the network:

1. Define which types of investors you are interested in and the characteristics of the raise.

2. Work with your financial institution to promote your company on the network.

3. Engage with investors coming through the network, looking for more information.

4. Be notified when investments come in, and the money is in the bank.

3. Simplified Legal and Regulation Compliance.

Simplified, unified, automated legal and regulation compliance.

The Pain:

Legal: today, every private company creates its own documents for every round. There are then multiple negotiations per round with various lawyers from all sides, each bringing their own unique agendas and idiosyncrasies into the process. This leads to complicated ownership structures, which may obfuscate the real valuation of the company, limit future rounds and secondary liquidity potential.

These structures are often the result of the stronger side's ability to exert pressure (usually the investor, and especially in a crisis), and traditionally serve a purpose at the stages of the company's lifecycle when the risk is higher and investors need more protections. In contrast, public market shares offer clear cut rights to investors with zero negotiation, and are therefore much easier to transact. The negative results of these inefficient private legal practices are measured in **legal costs, time, lost deals, and complex structures that prohibit future liquidity**.

It is possible that a reason for many complicated structures is the tradeoff between investor protections and tradability. The core risk in private companies is that the reward may potentially be very high, but only a percentage of companies end up exiting successfully or paying substantial dividends. The average time to exit has also increased in recent years. Therefore, for all investors in companies who would not eventually exit, having the **option** to partially liquidate holdings mid-way may be a better downside risk protection facility than adding protection measures into the documents (which often only protect in the case of some exit).

Regulatory: Regulatory issues mostly affect cross-border transactions, especially in secondary markets. The regulatory knowledge required to put such cross-border deals together is complicated and often unclear ("ask 3 lawyers, get 3 answers"). In practice - regulation is a barrier for the already difficult process of international private transactions.

The Cure:

Legal: Standardise. Get closer to the public model - this steering group will develop core templates for the definition of the digital shares class, and the conversion models from non-digital to digital shares. The advantages - one time effort, template based, same rules for all investors, which would open the optionality of frictionless liquidity.

Regulation: fully automated regulation using artificial intelligence.

Tasks for company joining the network:

1. Work with your legal team to set up and design the digital shares class (templates will be made available).

2. Work with your current shareholders on the terms of converting current non-digital shares to digital shares.

4. Transactions and investor management

The Pain:

Transactions across the private market are today managed manually. This is a slow, costly, error-prone and non-scalable process. It is less of a problem for a 5-investors transaction, but becomes an operational and scalability issue for 100+ investor rounds.

Cap table management is either done on spreadsheets, or via specialized services companies (where cap table management and auxiliary services are automated). In all of these options - updates and changes to the actual ownership following transactions, are still manual, and error prone.

In addition, managing processes such as dividend distribution, voting, and investor disclosures can be cumbersome, and inefficient.

The Cure:

The network will manage a live digital cap table for each company, where transactions are **instant, direct between the two sides to the transaction, including instant delivery vs payment, with minimal counterparty risk, and with instant finality.**

The basic information required to manage cap tables will then be available from the networks via an API, and so it can be easily pulled into a variety of 3rd party cap management service companies.

In addition, payment of dividends, can be simple and instant - and therefore may lead to a new set of business models based on the operational simplicity of paying investors.

> *Legal note: A common misconception is that digitally managed assets are bearer-shares and can be easily lost by the holder resulting in losses, or sold to anyone without the company's approval. However, this is not the case. Unlike Bitcoin which is indeed a bearer-like instrument. Digital shares are **NOT bearer instruments** - they are simply records of ownership in a ledger. The **company is still in control** of the cap table. So for example, the company can return shares to investors who have lost their online credentials, the company can cancel a fraudulent transaction, and the company remains in full control over who is authorized to buy shares. Again, what changed - is that the cap table is digitized, shares can be efficiently distributed online at scale to pre-approved inverter audiences, and transactions settle in seconds.*

Tasks for company joining the network:

1. Once an investment is made, it will show on your live cap table, and in your bank account (the investment itself).

2. You may use the network's API to connect to a cap table management service provider.

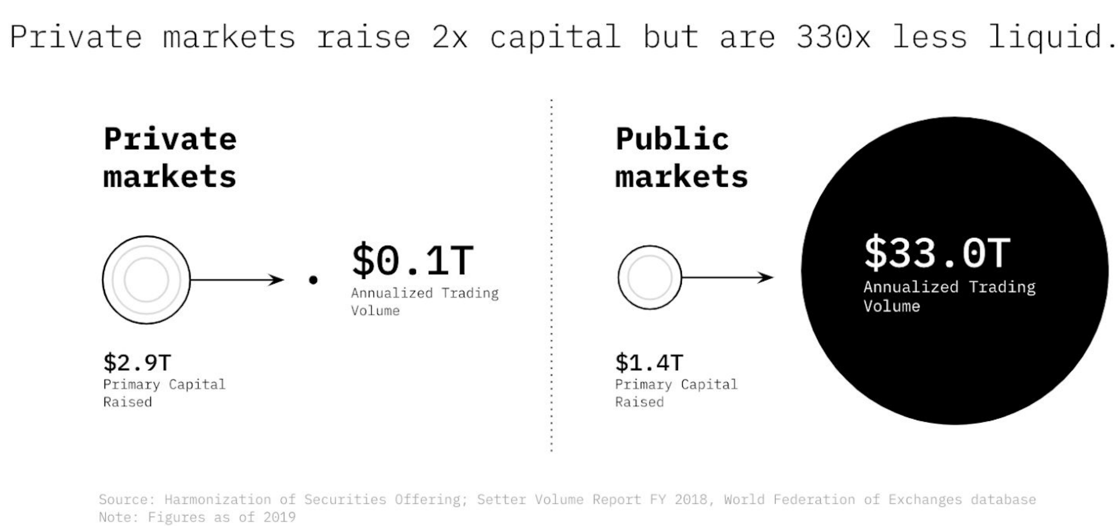
5. Secondary Trading - Liquidity.

Phase II

Efficient secondary trading support. Elastic control of timing/scope.

The Pain:

The vast majority of private assets are effectively illiquid. It is extremely hard to estimate the size of the asset supply that might be added to the market if frictionless trading and price elasticity would become available, because this has never been tested. The total value of private assets is in the hundreds of trillions, over $250 trillion in commercial real estate alone. Closer to this initiative, In the private companies space, there are a few trading venues that offer secondary liquidity, mostly in “unicorn” private companies, which could be demonstrating the potential, as well as the significant friction that is inherent to secondary liquidity in the market we have today.



Source: Tribe Capital

There are three main reasons why this market has so little liquidity today:

- Inherently, many private companies are less attractive for trading (high risk). However, many also offer greater growth opportunities, or are indeed attractive, but simply prefer not to go public. The real issue is lack of **price elasticity**. For example, an estimated 25-35% of private company stock is held by founders, management and early stage investors. Take for example the case of founders who find themselves holding shares worth $Xm (i.e “life-changing amount”) in a 3 years old company, which still faces another 5 years till a potential (maybe) exit. Then ask the "alternative cost" question: If they had the same $Xm amount at hand, would they choose to invest all of it in that one company? If the answer is no - then an option to sell a portion, represents a significant risk reduction **for them**, and therefore a discounted purchase opportunity for a bigger, long-term investor. Existing investors may not want founders to sell, so a solution must be flexible enough, for example to allow the company to enable partial conversion to digital securities at specific milestones ("Founders may convert x% of their holding to digital every year) etc.

- Lack of information. Private companies don't have to, and usually also don't want to share too much information. This is where we need to find the right balance as discussed above in the due diligence section.
- Lack of a frictionless market. Until a digital network will be in place, there are very few trading venues for these assets, and the friction is significant. Therefore, such venues only cater for companies of a certain size, deals are sometimes done via complex SPV structures or warrants rather than direct ownership of shares, there is very little price elasticity, transactions may take days or weeks, and may not be final until ROFRs are checked, and may force large minimum tickets. A digital securities market will streamline these processes dramatically.

The Cure:

The first phase of this initiative is about Primary raises rather than secondary. That said, several participants in the steering group already have the required licenses and operations, or are in various stages of obtaining the required licenses to engage in digital securities trading (over the counter, ATSs, full exchanges).

As in other pain points described in this handbook, the current market is very binary - a company is either Public and can trade frictionlessly, or is Private and effectively not tradable. Digitization provides the **price elasticity and frictionless distribution**, where some assets may trade more and others may still not trade at all, buyers and sellers from across the global network can name their price, and market players can index and bucket products to reduce risk and increase exposure and diversification.

Tasks for company joining the network:

1. Engage (directly or via your financial institution) with secondary trading platforms on the network to enable liquidity for your digital shareholders.

6. Business model for Financial Institutions.

A business model for financial institutions to bring their investor base.

The Pain:

The institutional financial industry does not currently have a viable model for engaging with most private companies below a certain size. This is not directly the problem of the companies - but without solving it, the financial institutions in the group would not have the incentive to operate the network and bring investors to invest.

The cost side: the current process for funding a company is slow, manual , and involves as much work, facetime and meetings for a mid-size deal as it would for a much larger deal (sometimes more). As a result, although institutions have the clients and relationships with potential investors - they are not active in the space below the top end.

The revenue side: the revenue potential for a smaller deal is dramatically smaller while the costs and effort are about the same. On top of that, there is no secondary market from which to generate additional revenues.

To harness the financial ecosystem to bring private companies to their client base, we therefore must enable their business model while making sure private companies only benefit from the new market.

The Cure:

Cost side: through digitization, automatization and systematization, as well as the increased distribution from an interconnected global network - we expect a strategic reduction of costs per deal for financial institutions. The automatization of manual processes also means increased scalability,

Revenue side: we prefer a model where most of the costs of coming onto the network will not fall on the company. The solution is to enable the financial institution to **generate revenues from secondary transactions**, which would therefore not come from the company itself.

Tasks for company joining the network:

1. Agree terms with your financial institution for the capital raise.
2. Agree terms with any secondary trading venues for secondary trades.

Conclusion

This document makes the case for digitising the private markets now. It has been written to brief private company executives and shareholders, support a debate, and offer a practical approach for private companies with an existing cap table to raise capital in an efficient and scalable way on a global digital institutional network.

It can be tempting to take a position that the private markets will not change; that the process of raising finance will continue the way it always has done, and that the only way to a return on investment in a private company is to wait until the exit. Yet, a global digital network offers such advantages and opportunities for capital formation and liquidity, that the transition to digital has already begun. Recent history tells us that when any market starts moving to the online world, there is no way back, only forward.

The opportunity that exists right now is for the financial ecosystem and private companies to be proactive and work together. The Covid-19 crisis is the catalyst, the opportunity for private companies to fund their growth in a new way, and help founders and investors be more successful, employ more people, spend more, and help the economy recover along the way.