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PPM Standardization in Security Token Offerings

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PPM Standardization in Security Token Offerings

By Dan Nossa, Steptoe & Johnson PLLC

When do you use a PPM?

In the United States, a private placement memorandum (“**PPM**”) is often used by businesses (“**Issuers**”) that are raising money through a private placement of securities. If an Issuer wants to sell securities,¹ the Issuer is required to either register the securities with the Securities and Exchange Commission (“**SEC**”) or avail itself of an exemption from registration. Most Issuers prefer to use an exemption because registering an offering with the SEC is a very costly and time-consuming process.

In the burgeoning security token offering (“**STO**”) industry, the most commonly used exemptions from registration are the ones provided under Rules 506(b) and 506(c) of Regulation D of the Securities Act of 1933. The detailed requirements of Rules 506(b) and 506(c) are beyond the scope of this discussion. Suffice it to say that these exemptions permit Issuers to avoid registration so long as they limit their sale to accredited investors.² When issuing securities to any investor, Issuers are subject to antifraud rules. In other words, Issuers cannot lie, misrepresent or withhold material information from the investors.

Strictly speaking, PPMs are not mandated by law. The SEC does not require Issuers to prepare a PPM for investors when they are raising money through a private placement. However, there are at least four practical reasons an Issuer should consider providing prospective investors with a PPM. First, PPMs can mitigate the risk of investor lawsuits. By providing thorough disclosure of the private placement, an Issuer has written proof that it made best efforts to disclose all material information to investors and did not violate the antifraud rules. Providing a PPM can make it harder (although not impossible) for investors to make a case that the Issuer sold them a bill of goods if the business goes sour. Second, accredited investors are often sophisticated individuals and institutions that have come to expect Issuers to provide a PPM. Third, if an Issuer tries to sell securities through a broker-dealer, the broker-dealer will require a PPM to provide its network of accredited investors. Fourth, a PPM can be an important marketing tool for the Issuer.

The primary feature that distinguishes an STO from more traditional private placements is that the investors’ stake in the Issuer is tokenized (i.e., the stake is recorded on a blockchain). Otherwise, STOs are subject to the same standards and the same expectations as traditional securities offerings. Therefore, Issuers looking to raise funds through an STO will likely be expected to prepare a PPM.

What is a PPM?

A PPM goes by many names. Some refer to it as a confidential information memorandum (CIM), a confidential offering memorandum (COM) or just an offering memorandum (OM). Regardless of what it is called, a PPM is a disclosure document prepared by an Issuer and its attorneys. The PPM is meant to inform investors about the business structure, legal terms and risks of the investment. The substance of PPMs is unique to each investment. The kind of information that is disclosed in a PPM largely depends on the industry (e.g., real estate, technology, energy, etc.) and the particular line of business of the Issuer. For example, the PPM prepared by an Issuer that is

¹ Securities include a broad spectrum of financial instruments, including, but not limited to, equity (such as stock in a corporation, LLC membership interests and limited partnership interests), debt and investments in a common enterprise with the expectations of profits solely from the efforts of the promoter or a third party.

² “accredited investors” refers to individuals with a net worth of at least \$1 million (excluding the value of their primary residence) or with annual income of at least \$200 thousand (\$300 thousand with their spouse) for the previous two years as well as certain institutions such as banks, insurance companies, and other businesses with sufficient assets.

raising funds to purchase an apartment complex will be different from the PPM for an oil & gas investment or a blockchain company. Nevertheless, there are general categories of information that are found in most PPMs regardless of the business of the Issuer, namely, (i) an executive summary, (ii) purpose of the business or project, (iii) details of terms and structure of the offering, (iv) use of proceeds, (v) financials, (vi) description of the sponsors or management team, (vii) risk factors, (viii) tax treatment, and (ix) legal terms. PPMs can range in length from a few dozen pages to well over a hundred pages (especially if you include exhibits, schedule and other attachments). The cost and time it takes to prepare a PPM can also vary depending on the complexity of the transaction. It can take a few weeks to a few months to complete a PPM. The legal costs range from a couple of thousand dollars to tens of thousands of dollars, again depending on the complexity of the offering.

Can PPMs be standardized for purposes of STOs?

Issuers that want to minimize the time and money that go into preparing a PPM may wonder if there are ways of standardizing and simplifying the process of preparation. This is especially relevant in the STO and digital asset space since entrepreneurs and existing businesses want to benefit from the efficiency and cost-cutting that blockchain technology is touted to provide. Having said that, the *format* of a PPM can certainly be standardized (and, as discussed above, many PPMs already follow the same general structure). The *substance* of a PPM, however, cannot be standardized as their purpose is to disclose the terms and risks of a particular offering. For instance, the description of the management team and the financials are unique to an Issuer, and the risk factors should be tailored to the particular risks of a project.

Even though the substance of a PPM cannot be easily standardized, there are ways to reduce the time and costs involved in preparing a PPM such as having the Issuer complete a comprehensive due diligence questionnaire that would elicit the substantive information about the offering that investors, broker-dealers and regulators require and expect. For example, the questionnaire can ask the sponsors of the Issuer to provide detailed answers to questions about the Issuer's purpose, the structure of the offering, the use of proceeds and the experience of the management team. The answers to these questions can then be used to complete a PPM template. Reasonably-priced online document preparation companies already offer this service by generating PPMs after prompting Issuers with a series of questions. There are also a number of websites that provide free or low-cost PPM sample forms for an array of different businesses. However, if an Issuer chooses to use these online document preparation services, it would still be in the Issuer's best interest to have an experienced securities lawyer review the PPM before it is offered to any prospective investors in order to avoid violating any antifraud rules and to ensure the PPM conforms to standard industry practices.

As the market for STOs matures, it is highly likely that STO platforms will enable more efficient ways for Issuers to prepare and convey a PPM to investors. An exhaustive on-boarding questionnaire and a process that populates the standard format of a PPM with the regulatory-compliant information provided by the Issuer is probably just a first step. As companies begin storing records on a blockchain (as has been explicitly permitted by a series of new laws in Delaware), much of the information that is disclosed in a PPM in the future could be generated by having the STO platform communicate directly with the Issuer's blockchain records.

Can a PPM be represented or replaced by smart contracts?

A discussion that comes up a lot in the blockchain and digital asset space is whether smart contracts can be used to replace traditional legal instruments, such as agreements between parties.

Indeed, there are a lot of projects in the works to create smart contract standards. There are also many startups that are carving out a niche in the legal tech industry that purport to enable transactions that would be subject to smart contracts rather than traditional legal contracts. This raises the question of whether PPMs can be replaced by smart contracts. The short answer is no. A smart contract is code embedded in a blockchain that enables the transfer of value upon the satisfaction of certain conditions (e.g., upon the delivery of a certain good or completion of a certain service, whether real or digital, value (such as digital currency or some other form of consideration) is transferred from one party to the other party). PPMs, however, are not contracts. They are disclosure documents that are meant to convey investment information to prospective investors in an intelligible (plain language) form. Smart contracts are written in a computer language that is not intelligible to the average investor. Although it is possible to imagine a future in which investor interests are represented by AI-enabled analytical software that can read a disclosure document written in computer language, it is not happening this year.

About the Author



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