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Introduction of the Japanese Version of "SAFE" for Venture Investment

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1. What is "SAFE" ?

Since the Simple Agreement for Future Equity ("**SAFE**") made its debut in 2013 via Y - Combinator,[1] it gradually has come to be recognized as an effective investment instrument, especially for early-stage startups in the United States. Through SAFE, investors have the right to convert the value of their investment into shares of the issuer upon predetermined event triggers. Such future events are usually the issuer's next priced equity round.[2]

The advantages of SAFE venture investments can be divided into three categories. First, investors need not (i) calculate the enterprise value of issuers at the time of investments through SAFE and (ii) implement due diligence of issuers before determining investment conditions. As a result, investors achieve consummating investment easily and quickly. Second, neither investors nor issuers take steps to enter into shareholder agreements at the time of the original investment. SAFE investors will become the shareholders through SAFE conversions upon the predetermined triggering event. Third, SAFE investors normally have an entitlement to turn their payment amount into issuers' shares under more profitable conditions than investors in later financing stages. At the next equity financing round, SAFE investments convert into issuer equity after taking into account any early-stage incentives (i.e., valuation caps or discount rates) relative to the price paid by the later investors. In exchange for SAFE investors' cash payment to startups without valuing how much such startups are worth, SAFE investors can receive such incentives as a "thank you" for their early investment (and elevated risk).

SAFE also is entrepreneur-friendly in some respects. Unlike funding by notes and/or debts, startups need not repay money made through SAFE. Not having a repayment requirement takes time pressure off startups. As such, startups can use invested funds as their working capital and concentrate on accelerating their sales and revenues. Another advantage is that startups may adopt simple governance structures. As mentioned above, none of the SAFE investors become shareholders until predetermined events occur, and thus, SAFE investors are not expected to sign off on the startups' decisions or attend shareholders' meetings. These advantages contribute to a quick and straightforward fundraising process for startups.

Despite these advantages, SAFE has not yet been widely used in Japan for venture finance. This article introduces how to invest in Japanese startups through SAFE with the goal of furthering, simplifying, and streamlining the venture financing system, and in the process, increasing the popularity of SAFE in Japan.

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1 https://www.ycombinator.com/documents.

2 "Priced rounds" are equity investments based on a negotiated valuation of a company. For most early-stage companies, those will be series seeds or series A financings.

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2. How do Japanese startups issue "SAFE" under the Companies Act?

(1) Share Options

Under the Companies Act of Japan (the "**Companies Act**"), Japanese Companies (*Kabushiki kaisya*) may issue Share Options (*Shinkabu yoyakuken*). Share Options are the right the holder exercises to acquire shares of issuers. No holders of Share Options become shareholders until they exercise Share Options, and the issuers then deliver their shares to the holders.

The key features of SAFE are that (i) SAFE investors become shareholders of issuers upon event triggers, and then (ii) they can convert their investment money into issuer shares. These characteristics are similar to the Share Option mechanism, which allows holders to obtain issuers' equity by exercising such options. Accordingly, it is considered that Japanese startups can raise money through SAFE by utilizing Share Options under the Companies Act.

(2) Primary Contents of SAFE

(a) Outline

When startups issue SAFE by way of issuance of Share Options under the Companies Act, they must determine some of the material contents of Share Options (i.e., SAFE): (i) the number of the shares underlying Share Options or the method for calculating that number; (ii) the conditions under which investors may exercise Share Options; and (iii) the grounds upon which Share Options are automatically acquired by issuers. The following items (b) through (d) consist of concise breakdowns of each of these matters.

(b) Method for calculating the number of the shares underlying SAFE

Under the Companies Act, if startups issue SAFE, they determine the total number of shares that SAFE investors acquire upon a future conversion. As noted in item (a) above, it is permissible for startups to determine calculation methods for the number of shares that SAFE investors receive when their investment money through SAFE converts into such shares instead of deciding upon an exact number.[3]

SAFE investors typically are provided with relative incentives (i.e., valuation cap, discount rate) to the later investors in the next priced financing round, as described in 1 above. The valuation cap is the maximum valuation of startups at which SAFE converts. Valuation caps are designed to provide a ceiling on the price that SAFE investors would be deemed to pay for the shares they get on conversion. The discount rate is the rate by which the price per share that SAFE converts into is discounted compared to the price applied to the next equity financing round. Which incentives are incorporated in SAFE is determined on a case-by-case basis, and some SAFE have both of these incentives.

When issuing SAFE, one or both incentives should be determined and crafted as contents. If a SAFE includes both incentives, the SAFE is converted only under the more favorable condition among the two incentives.

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[3] Under the Companies Act, SAFE conversion shares can be calculated on a post-money basis.

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(c) The conditions under which holders may exercise SAFE

Under the Companies Act, startups may set conditions for exercising SAFE to convert into shares thereof. As explained in 1 above, in the case startups raise money through SAFE, SAFE investors turn their paid-in money or investment into equity when the future event triggers conversion. Unless such future event occurs, the SAFE investment will not be turned into shares. From the viewpoint of SAFE investors, the dependence on a future conversion leads to the risk that they will not hold equity in the startup.

To follow with such salient feature of SAFE, the occurrence of the next priced equity round should be a condition for exercising SAFE. Following exercising SAFE, startups should deliver shares equal to the number calculated by using incentives (i.e, valuation cap and/or discount rate (See item (b).).

Additionally, in practice, a dissolution event or the sale of startups' businesses (i.e., a liquidation event) are potential SAFE conversion triggers. As such, the occurrence of a dissolution event or the sale of the business are generally considered exercising conditions. In the standard treatment, in the case a dissolution event occurs, SAFE investors may receive back their original SAFE investment amount. In the case of business sale, SAFE investments generally either convert into shares or are paid back in the original amount, whichever of the values are higher.

(d) The grounds where SAFE are automatically acquired by startups

Under the Companies Act, startups may determine any grounds where SAFE are automatically acquired by them. As described in item (c) above, in practice, the occurrence of the next priced financing round, the sale of the business, and a dissolution event are the predetermined events that trigger SAFE conversion. Thus, those events are incorporated into the grounds where SAFE investments are automatically converted into the startups' shares. From a practical standpoint, these grounds will be activated when SAFE investors do not exercise SAFE even when a predetermined event occurs and the exercising condition (see item (c)) is met.

Under the Companies Act, in the event startups acquire issued SAFE under such grounds, they may deliver their equity or cash to SAFE investors as considerations in return for obtaining SAFE. As described in item (c) above, if startups acquire issued SAFE, upon the occurrence of the priced equity round, they usually deliver the number of shares determined by their proclaimed calculation methods to SAFE investors. On the other hand, following a dissolution event, they deliver the invested original amount to the SAFE investors. In addition, when carrying out the sale of the business, which of the shares or cash return options shall be employed depends upon the contents of the SAFE.

(e) Other

Under the Companies Act, SAFE investors may be required to pay money in exchange for subscribing to a SAFE. SAFE investors then make a cash payment equal to the amount agreed upon with startups to receive the SAFE.

3. Primary practical tips when issuing SAFE in Japan

(1) Setting a valuation cap and/or discount rate

Some of the virtue of SAFE includes eliminating the need to set a valuation so that startups raise money as soon as possible. Due to not having to value a startup's business at the time of fundraising through SAFE,

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by applying incentives mechanisms (i.e., valuation cap and/or discount rate) at the time of SAFE conversion, SAFE investors can receive more favorable terms than the price later investors pay. Since the exact amount of a valuation cap and/or the precise percentage of discount rate are critical issues to affect such favorable terms, startups and potential investors should negotiate those accordingly.

(2) Documentation of SAFE contents

Once reaching a mutually agreed material contents for a SAFE, as set out in item (b) in 2 above (including valuation cap and/or discount rate), startups create a document describing all the SAFE contents, which will be a part of an investment agreement (see item (3) below) entered into among startups and SAFE investors.

(3) Investment agreement

Along with negotiating SAFE contents, startups and SAFE investors need to negotiate terms and conditions of investment agreements; provided that content is relatively simple. Unless a trigger event occurs, SAFE investors are not the shareholders of startups and don’t have the statutory rights granted to shareholders under the Companies Act. Given that none of the shareholders’ statutory rights are provided for SAFE investors, contents of investment agreements usually need not set forth their governance rights, such as veto rights and appointment rights for directors, as may be provided in shareholder agreements in standard equity financing cases. Startups do not require lengthy negotiations, resulting in achieving quicker access to financing. Nevertheless, startups and SAFE investors are able to set forth such governance rights in the investment agreements on a case-by-case basis upon consultation and mutual agreement. One of the core concepts of utilizing SAFE is to achieve a simple and quick financing process. When negotiating, parties must keep in mind that lengthy negotiations would jeopardize such core concepts.

4. Conclusion

Although SAFE is not an ideal instrument for every case, SAFE has some startup-friendly and investor-friendly aspects. To facilitate quick capital injection into startups, it is preferable that many startups and investors consider utilizing SAFE in the Japanese venture financing market.

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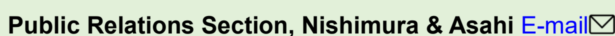
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