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SAFEs as (New) Financing Instruments

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Introduction

Simple agreements for future equity (SAFEs) are financing instruments that may be used to raise capital in seed financing rounds. Generally, such financing instruments are viewed as a more founder-friendly alternative to convertible notes on an international level. A SAFE is an investment agreement that gives the investor the right to receive equity of the company under certain circumstances. In 2013, the American startup accelerator Y Combinator introduced the first SAFE, which was based on a pre-money valuation. However, in 2018, Y Combinator amended the form of the SAFE to be based on a post-money valuation.

SAFEs or SAFE-like instruments are used in many jurisdictions, such as in Austria, Germany, Italy, Norway, Sweden and the United Kingdom. However, this article describes the most relevant aspects of SAFEs from a United States, UK, Austrian and Swedish law perspective. Further, it elaborates on the most frequently used types of seed financing instruments as an alternative to SAFEs in the relevant jurisdictions, including convertible notes (also referred to as convertible promissory notes or convertible loans).

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SAFEs in the US

Introduction

In the US, SAFEs are a type of convertible security typically sold by venture-backed companies in order to raise capital before or between priced equity rounds.

As indicated above, SAFEs were originally created by Y Combinator – an influential American startup accelerator – as a standardised means of investment into its portfolio companies. Due to their relative simplicity, low transaction costs and initially founder-friendly terms, SAFEs have quickly grown in popularity and have become the go-to method of bridge financing for early- and growth-stage companies in the US, and in many cases have taken the place of early equity financing rounds altogether.

Similar to convertible promissory notes, the prototypical SAFE allows a company to raise capital upfront with the expectation of later converting that liability into shares of next-round preferred stock. Unlike convertible notes, however, SAFEs do not have interest rates, maturity dates or other common features of debt, removing points of potential negotiation about 'market' terms and avoiding many of the legal and business complications associated with debt financing.

The ability to treat the SAFE as a true equity investment, together with the proliferation of generally accepted standardised forms from Y Combinator, has allowed companies to raise capital from investors much more cheaply and efficiently than was previously possible.

Types of SAFEs

Today, there are essentially three types of provisions that can be used, either independently or in some combination, as the underlying economic terms of a SAFE:

(1) discount rate;
(2) valuation cap, which, as described below, can be 'pre-money' or 'post-money'; and
(3) most-favoured nation (MFN).

Discount rate

The discount-only SAFE is, in many ways, the simplest and most straightforward form of SAFE. In a discount SAFE, the purchase amount under the SAFE converts into preferred stock in the next financing round, at a price per share equal to: (1) the lowest price per share of the standard preferred stock (ie, next-round shares) sold in the equity financing, *multiplied by* (2) the discount rate. In other words, in exchange for putting in capital today, an investor gets to convert the SAFE into next-round shares at a fixed percentage discount on the purchase price paid by new-money investors. The defined term 'discount rate' used in the standard Y Combinator SAFE is the percentage paid rather than the percentage discount – meaning a discount of 20 per cent would correlate to a 'discount rate' of 80 per cent. This can often change though with third-party forms, so it is best to double check how the definition is used in order to confirm the appropriate number.

From an investor's perspective, the benefit of the discount-only SAFE is the relative simplicity and the guaranteed discount on the next round. There is less urgency to independently confirm a given valuation of a company or worry about a company underperforming projections; as long as the company raises money in a priced round at a fair price, the investment will convert to equity at a favourable rate at the time of conversion. On the other hand, the investor potentially loses out on gains from rapid growth, and the higher the price of the next round, the higher the price at which the SAFE will convert – meaning fewer shares for the investor.

Valuation cap

Instead of a fixed discount rate, a valuation cap-only SAFE converts into preferred stock in the next financing round at a price per share equal to: (1) a fixed valuation cap amount, divided by (2) the number of outstanding shares of the company's fully diluted stock at the time of the subsequent financing. This allows investors to participate in a company's upside, as the higher the next round valuation, the greater the effective discount received by the SAFE investor. However, this approach also comes with a risk – in the event that the value of a company does not grow as expected (ie, does not exceed the valuation cap), a valuation cap-only SAFE will simply convert at the same price per share paid by new investors, and the SAFE investor receives no excess benefit for the risk related to the earlier investment.

One beneficial component of a valuation cap SAFE is that one can calculate the percentage of the shares in the company that the SAFE would convert into by dividing (1) the purchase price of the SAFE by (2) the valuation cap. For instance, if someone invests $50k based on a $5m cap SAFE, that SAFE will convert into shares representing one per cent of the relevant company.

Pre-money versus post-money valuation caps

Somewhat confusingly, there is a distinction between a 'pre-money' valuation cap and a 'post-money' valuation cap – or more accurately, a distinction in the way a company's capitalisation is calculated when determining the conversion price of a 'pre-money' and 'post-money' SAFE.

The 'pre-money' SAFE was the original form created by Y Combinator back in 2013, and it expressly excludes the shares issued upon conversion of SAFEs or other convertible securities from the company's fully diluted capitalisation for purposes of calculating the conversion price. Here, the SAFE holder is diluted along with all the existing stockholders when the other SAFEs and convertible securities convert at the next financing round.

The 'post-money' SAFE, which is the form currently used by Y Combinator, expressly includes the shares issued upon conversion of SAFEs or other convertible securities in that same calculation. The post-money SAFE is essentially designed with the realisation that companies are using SAFEs as independent financing rounds, and works to prevent dilution to the SAFE holder from the conversion of SAFEs or other convertible securities.

In a pre-money SAFE, that one per cent example above gets diluted by all other SAFEs converting at the same time, which can be tricky for a company to predict and for investors to calculate. A post-money SAFE, on the other hand, here would continue to represent one per cent of the company as of immediately prior to the subsequent financing regardless of how many other SAFEs were issued prior to conversion. Note that in both cases, a SAFE holder would still get diluted by the new money investors in the preferred stock financing; the 'pre-money' versus 'post-money' nomenclature refers to the capital invested in the SAFE round (and any other convertible rounds) itself, not the new money investment that triggers conversion.

Valuation cap and discount

A valuation cap and discount SAFE combines the 'best' features for investors of both a discount conversion and a valuation cap conversion, using whichever conversion results in a lower price per share. These types of SAFEs remain prevalent but, given the multiple methods for determining a conversion price, can introduce some complexities for companies and investors in modelling conversion scenarios.

Most-favoured nation

If a company issues a subsequent SAFE or other convertible security on better terms than the original SAFE, an MFN provision allows holders to convert their original SAFE into that subsequent SAFE or other convertible security. An MFN-only SAFE relies on that concept to allow companies to raise early capital even if it is unsure of what terms to offer under a standard (eg, discount or valuation cap) SAFE.

MFN-only SAFEs are not so common, but their existence as a form of bridge financing to a more typical SAFE, which was traditionally considered a form of bridge financing itself, speaks to the increased use of SAFE rounds as an alternative to traditional preferred stock financings. However, an MFN provision is used with some frequency in connection with a valuation cap, discount, or both, in order to offer a level of 'future-proofing' to early investors.

Negotiating a SAFE

Given the widespread use of standard forms issued by Y Combinator and a key benefit of the SAFE being reduced transaction costs, there often are relatively few negotiated legal points within the SAFE itself once the type of SAFE and the economic terms above have been determined. However, some third-party forms will tweak certain terms to be more investor or founder favourable, including:

1. inclusion or exclusion of items from 'company capitalisation' calculations in a valuation cap SAFE, such as the reserved option pool, promised but unissued options or increases to the option pool made in connection with a priced round;
2. treatment upon a liquidation event or deemed liquidation event, including rights to convert into common stock (or the latest round of preferred stock) or to receive some multiple of the purchase price;
3. including a provision regarding an optional conversion (or repayment) upon a subsequent maturity date to address the issue that a standard form of SAFE has no set expiration date, in the absence of a conversion event;
4. adding an MFN provision to another type of SAFE; or
5. adding information rights, rights of first offer or other rights commonly provided to preferred stockholders.

With respect to 5 above, these types of rights will often be granted to large investors in a SAFE round via a side letter with the company, which allows for certain individualised terms without requiring the company necessarily to provide the same rights to each other investor. Side letters are typically more heavily negotiated than the form of SAFE itself, though Y Combinator does provide a form of pro rata rights side letter that can be used. There is also an administrative risk with issuing too many side letters on non-standard forms, as companies and their counsel will have to review each agreement on a regular basis to ensure continued compliance.

Conclusion

During the almost decade that has passed since the introduction of the SAFE by Y Combinator, these forms of agreement have gained increased acceptance in the startup community as a means to more easily facilitated early-stage financings where valuations are uncertain and also to serve as a bridge between growth rounds at more mature companies. The ability to treat the SAFE as a true equity investment, together with the proliferation of generally accepted standardised forms, has allowed companies to raise capital, whether it be $50k or $5m, more cheaply and efficiently than was previously possible.

SAFEs in the UK

First, the UK includes three legal jurisdictions, namely those of England and Wales, Scotland and Northern Ireland. All three are common law jurisdictions and their laws largely derive from the same sources and share many features, particularly in matters of corporate and commercial law. However, the following explanation – on how SAFEs are used in the UK – is written from the perspective of the laws of England and Wales only.

In the UK, SAFEs are known as advance subscription agreements (ASAs) (for reasons that we come onto below). ASAs have become very popular among startups over the past five years and particularly since the Covid-19 pandemic.

Introduction

Historically, bridge funding between rounds for UK startups has been dominated by convertible loan notes (CLNs) or convertible loan agreements (CLAs). These provide certain advantages for investors, principally that they constitute a debt, and this gives the investors priority over shareholders in the event of a winding up. CLNs and CLAs achieved particular popularity during the pandemic, as this structure was used by the UK government's Future Fund programme to provide financing for qualifying startups during the downturn. The Future Fund programme was very widely used and has resulted in a standardised set of CLN/CLA terms, which helps to streamline future CLN/CLA-based financings.

However, CLNs and CLAs also have certain disadvantages:

- From the perspective of the startup, CLNs and CLAs appear as a debt on the balance sheet, which can make negotiations with customers and suppliers more difficult.
- From the perspective of the investor(s), CLNs/CLAs are not eligible for the UK's principal tax relief schemes designed to promote equity investment by private UK investors into startups: the Enterprise Investment Scheme (EIS) and the Seed Enterprise Investment Scheme (SEIS).

A brief note on EIS and SEIS

The EIS and SEIS schemes provide tax breaks to individual UK taxpayers who invest into the ordinary equity of startups and early stage companies.

In very broad terms, if an investment qualifies for EIS treatment then investors are:

- entitled to set off 30 per cent of the investment amount against their income tax liability for the year in which the investment is made (under the SEIS scheme, the figure is 50 per cent);
- exempt from capital gains tax on a disposal of the qualifying investment; and
- entitled to set off any loss on a disposal of the investment against their income tax liability in the year of the disposal.

As regards income tax, the relevant tax legislation is contained in the Income Tax Act 2007 (Part 5 for EIS/Part 5A for SEIS).

As regards capital gains tax, the relevant tax legislation is contained in the Taxation of Chargeable Gains Act 1992 (sections 150A–C and Schedule 5B for EIS/sections 150E–F and Schedule 5BB for SEIS).

It is possible for investors to invest into EIS-specific funds, which use nominee vehicles to hold the shares in the underlying companies on behalf of the ultimate individual investor. EIS funds have become very popular.

Venture capital trusts (VCTs) (which are investment vehicles that are listed on the Official List of London Stock Exchange or on any 'European Union Regulated Market') have similar characteristics to EIS funds.

As can be expected for such generous reliefs, the conditions for qualification are tightly defined in order to ensure that the relief is only used for the right kind of investment (full-risk equity) into the right kind of business (early stage, small-medium, innovative). The reliefs can be lost not only if the issuing company ceases to carry out a 'qualifying trade', but also if the terms of the investment entitle the investor to be repaid or to receive funds on a return of capital in priority to ordinary shareholders. This means that convertible loans are not generally eligible for EIS or SEIS relief, but ASAs can be.

ASAs

As a solution to the disadvantages with CLNs/CLAs identified above, investors and startups became interested in the SAFE agreement, which had seen such popularity in the US since its introduction in 2013.

However, investors and startups quickly realised that it was not possible simply to download a copy of Y Combinator's SAFE and use it for a UK company because the SAFE is designed to comply with US law and is not compatible with English law or practice.

This is partly because the SAFE nomenclature (common stock, safe preferred stock, etc) does not match reality when the conversion event takes place and partly because the statutory references and associated definitions are US-specific. Further (and more fundamentally), the US-style SAFE works on the basis that the invested amount 'converts' into equity – this is not a concept that is recognised in English law.

Therefore, the ASA has been developed in order to replicate, as far as possible, the commercial effect of a SAFE in a manner that is compatible with English law.

ASAs work principally as follows:

1. the investor agrees to pay a sum of money to the company;
2. the company agrees to use that money to grow its business;
3. the investor agrees that the funds are not repayable;
4. the company agrees that, on a specified future event, it will use the subscription money to pay up the investor's subscription for new shares;
5. the future events that trigger subscription are:
   - a qualifying equity fundraising (normally assessed by reference to a minimum aggregate raise amount);
   - a non-qualifying equity fundraising where the investor requests that the subscription be completed;
   - a sale of the company or other major liquidity event;
   - an insolvency event, liquidation or winding up of the company; or
   - a long-stop date;
6. as an incentive to encourage the investor to advance the advance subscription funds, the subscription price for the new shares is generally set at a discount to the lowest price that is used on the event which triggers the conversion (where that event is a winding up, insolvency event or the long stop date, there is typically a default valuation);
7. to protect investors against excessive dilution, it is common to include a maximum valuation cap for the purpose of determining the subscription price; and
8. the shares for which the investor will subscribe are typically required to be of the most senior-ranking class of shares that will be in existence immediately following the triggering event.

Because the subscription price is based on the price per share that is paid in the event that triggers the subscription, this generally equates to a pre-money valuation being used (as distinct from the post-money position in the US that is referred to above).

In late December 2019, His Majesty's Revenue and Customs (HMRC) (the UK’s tax authority) updated its Venture Capital Reliefs Manual in order to clarify that, subject to meeting certain criteria, investment via an ASA can qualify for EIS and SEIS tax relief. The principal criteria (which may differ from the standard ASA terms) are as follows:

- the subscription payment may not be refunded under any circumstances;
- the subscription payment may not bear interest;
- the ASA may not be varied, cancelled or assigned;
- the subscription shares must not have preferential rights on a winding up (a so-called liquidation preference) and so may not be capable of being in the most senior ranking class following the triggering event (depending on the drafting of the share rights); and
- the long-stop date may not be more than six months after the date of the advance subscription payment.

The principal advantages of ASAs as opposed to other forms of startup financing are:

- Time and simplicity: direct equity fundraisings can be time-consuming, complicated, and costly to negotiate and implement. ASAs enable the negotiation of an exact valuation and the detailed corporate governance terms to be deferred until a later date and can therefore enable the company to obtain funding more quickly.
- From the investor’s perspective, the discount on conversion can be attractive.
- Unlike a CLN, an ASA does not appear as a debt on the company’s balance sheet.
- If structured correctly, ASAs can enable their holders to qualify for SEIS or EIS relief.

The principal disadvantages and risks of ASAs as opposed to other forms of startup financing are:

- From the investor’s perspective, ASAs are riskier than direct equity investments and much riskier than CLNs: indeed, they provide almost no downside protection for investors.
- The size of the discount may be off-putting to future investors if it means that the ASAs will excessively dilute other shareholders.
- Any maximum valuation cap may discourage raising at a higher valuation in future because it could result in additional dilution in such circumstances:

it also needs to be negotiated and agreed, which detracts from the time savings identified above.

- ASA investors can end up with more rights and ranking higher up the equity than they would have done had they made a direct investment due to sharing in rights that are negotiated by incoming investors.
- Where there is conflict between a potential new investor and existing ASA investors both wanting to preserve their position, the founders and/or existing shareholders may end up being squeezed in the middle.
- The threat of conversion on the long-stop date at a low valuation can add an extra timing issue, which can put pressure on founders to agree to unfavourable terms.

Conclusion

Provided that investors, company and founders approach the negotiation of an ASA with a good awareness of the associated risks, this can be a highly effective means of raising equity-based bridge funding quickly and cheaply.

ASAs are now a tried and tested solution in the UK, have a strong track record in UK venture capital financings, and have a well-understood and sophisticated set of standard terms.

SAFEs in Austria

Introduction

SAFEs are used to raise capital in the seed financing rounds of startup companies and may be considered a more startup and founder-friendly alternative to convertible loans. A SAFE is considered, in particular, when a prototype exists and market entry is foreseeable; the business plan is potentially not yet fully developed, but a scalable business model suitable for venture capital exists.

Since its introduction, the SAFE has been used by many startups and investors, in particular, in the US. In Austria, SAFEs have been used as an instrument for early-stage financing only relatively recently. Therefore, the Austrian startup-finance ecosystem does not yet have standard form documents.

Convertible loan

Prior to the introduction of SAFEs in Austria, convertible loans were often used as a financing instrument for various purposes in the early stages of a company, when the company was in need of short-term or medium-term financing. In particular, convertible loans help to keep the cap table clean until the equity financing round.

The provisions and structure of convertible loans may vary significantly depending on the purpose of the convertible loan. Commonly, convertible loans can be converted into equity under certain circumstances, whereby the lender will not become a shareholder of the company upon effectiveness of the CLA. Rather, the lender is usually entitled or required to convert the loan amount into equity, depending on the conditions set out in the CLA. The right to convert grants the right to request the conversion of the loan into equity. In case of such an obligation, the relevant parties are required to convert the loan into equity under certain circumstances.

Generally, a convertible loan is repayable and commonly qualifies as a debt investment that only turns into equity upon conversion. Compared with a convertible loan, a SAFE does not grant the investor any repayment claim and is therefore qualified as equity.

Structure of Austrian SAFEs

From an Austrian law perspective, a SAFE is an investment agreement between a startup, its shareholders (the founders) and an investor, which entitles the investor to receive equity of the startup company upon certain triggering events, such as a future equity financing. Therefore, the investor does not acquire the position of a shareholder by executing the SAFE. Commonly, the conversion of the SAFE is executed by way of an ordinary share capital increase (see section 52 of the Austrian Limited Liability Companies Act to the extent that the startup company is a limited liability company) in which the SAFE holder is admitted to subscribe for the capital increase to the extent agreed in the SAFE. In the event of an ordinary share capital increase, all shareholders holding a share of the company at the time of the conversion of the SAFE commonly agree to waive their statutory subscription rights (see section 52(3) of the Austrian Limited Liability Companies Act) without consideration with respect to the shares issued to the SAFE holder and pass all resolutions necessary to implement the issuance of the new shares to the SAFE holder.

Normally, the price of the shares that the SAFE holders receive on conversion is lower than the price of the shares issued to other investors in connection with equity financing, based on either: (1) a discount rate; (2) a valuation cap; or (3) both.

SAFEs may have similar conversion parameters to convertible loans but do not contain debt elements:

- Typically, a SAFE has no long-stop or maturity date, that is, SAFEs remain outstanding until a conversion event, liquidation event or dissolution event.
- Further, the SAFE amount does not bear any interest, that is, typically (and ideally) the SAFE holders receive a right to convert their SAFEs into equity at a lower price than the investors in the subsequent financing (based either on the discount or valuation cap in their SAFEs) and the right to receive a portion of the proceeds in the case of a liquidation event or a dissolution event subject to certain (mandatory legal) requirements and to the extent the proceeds are available for distribution.
- Usually, a SAFE does not grant the investor any repayment claims and qualifies as equity, whereas – as set out above – a convertible loan is repayable and commonly qualifies as a debt investment that only turns into equity upon conversion (commonly in the course of the equity financing).

SAFEs often contain certain representations and warranties from the existing shareholders and/or the company (eg, title and ownership, intellectual property, material agreements and compliance). The scope as well as the effective date of such representation and warranties are commonly determined in the SAFE.

Usually, SAFE holders (in particular, the lead investors) request the establishment of an advisory board or a similar body for which the lead investor is a member and possesses information, consent or veto rights with respect to certain business and/or corporate measures. This request is in many cases justified, as the SAFE holder is not a shareholder of the company and therefore does not have any voting rights in the company until conversion of his/her investment.

Generally, any agreements on the transfer of shares of a limited liability company must be executed in the form of a notarial deed. There is no case law from the Austrian Supreme Court whether SAFEs also require a notarial deed. In order to avoid the risk that the conversation of the SAFE into equity is not enforceable, it is recommended that the parties to a SAFE execute the SAFE in the form of a notarial deed. This also applies to CLAs.

In Austria, the structure of SAFE investments with respect to the funding of startups vary. Several aspects need to be considered when structuring SAFE investments, and specific legal requirements under Austrian law must be respected. This also means that the SAFE forms developed in the US must be adapted to mandatory Austrian law requirements, that is, the aforementioned Y Combinator forms must be amended accordingly in order to ensure that the SAFE can be enforced under Austrian law. Further, the SAFE structure has to consider various tax aspects, which need to be carefully assessed on a case-by-case basis and reflected in the SAFE.

The taxation of a SAFE depends, inter alia, on whether a SAFE investment is considered to be debt or equity for tax purposes. In particular, a profit-based remuneration, lack of collateral and a share in the current profit and the liquidation proceeds is required for an investment to be considered as equity. Non-residents are taxed on capital gains only in equity positions reaching one per cent or more of the capital share, whereby no taxation would occur in Austria under the majority double tax treaties.

Further, the qualification of a SAFE as a silent partnership – before a conversion into equity – may be relevant from a tax perspective. A silent partnership with participation of the silent partner in the hidden reserves and the goodwill, which constitutes a form of equity financing, is treated as a partnership for tax purposes. Any profits that arise from a partnership would be taxable at 25 per cent corporate income tax (see section 22 of the Austrian Corporation Tax Act). The risk of a SAFE qualifying as a silent partnership may be decreased or avoided depending on the structure of the relevant SAFE. However, such risk is only limited to the period prior to the conversion, that is, after the conversion, corporate income tax on profits from a partnership would not be triggered.

Conclusion

In addition to convertible loans, a SAFE is a startup and founder-friendly financing instrument, which has now arrived in Austria but which requires careful structuring (from a tax perspective) and respect for Austrian mandatory law requirements. The startup company receives the funds within a short period following the execution of the SAFE, and the investor receives his/her equity stake at a later stage, that is, the parties involved are not required to determine the valuation of the company prior to the execution of the SAFE. Based on our experience, the importance of SAFEs will continue to grow in the Austrian startup landscape.

SAFE-like instruments in Sweden

Introduction

As in the UK and Austria, the Y Combinator's standard documentation for SAFEs does not work *as is* in a Swedish context. The SAFE nomenclature (common stock, safe preferred stock, etc) also creates issues in relation to Swedish law. Even more importantly, the concept of the invested amount 'converting' into equity without any involvement of the shareholders in the company at conversion only applies if the SAFE is structured as a 'convertible instrument' as defined in the

Swedish Companies Act (see chapter 15 of the Swedish Companies Act). Even if it may be possible to adapt the US documentation to work in a Swedish limited liability company, this requires extensive amendments to the documentation and would remove some of the benefits of using the SAFE, such as limiting the need for drafting documents and avoiding lengthy negotiations between the parties involved.

Historically, convertible instruments have, to a more limited extent, been used in Sweden as an alternative to priced equity rounds in early-stage investments, such as pre-seed or seed rounds, and as bridge financings in between equity investments. As mentioned previously in this article, a convertible note is considered as debt and not equity on the balance sheet of a startup and could therefore be a less attractive investment alternative for the company. Under Swedish company law, there are also strict requirements to follow in the case in which the share capital of the company is at risk of being consumed, to avoid personal liability for the directors of the board and a potential obligation to have the company liquidated (see chapter 25, sections 13–20 of the Swedish Companies Act).

To mitigate some of the disadvantages of convertible instruments, different ways to structure convertible notes without an obligation for the company to repay the loan amount have appeared on the Swedish market in recent years. These would allow the convertible note to be considered as equity on the startup's balance sheet. However, even if these kinds of structures are more frequently used, so far, no sophisticated standard terms for a non-repayable convertible note have emerged on the Swedish market and it is still to be seen if this will be developed in the future. A non-repayable convertible instrument may still be questioned by certain auditors and the terms of the instrument will need to be negotiated and agreed and therefore the time savings that US founders and investors experience when using a SAFE will not materialise in Sweden. The uncertainty and the potential disadvantages of the convertible instrument may have caused a more modest increase in the use of convertible notes in Sweden compared to other jurisdictions.

A few years ago, a new instrument was introduced on the Swedish market by Erik Byrenius, a Swedish entrepreneur and investor. This new instrument is called warrants for investment in startup equity (WISE) and standard documentation for the instrument is freely available via StartupTools, a platform for legal documentation for startups (founded by Erik Byrenius). When introducing the WISE, the intention was to create an instrument that would have similar characteristics to a SAFE. The WISE is based on warrants (*teckningsoptioner*) according to chapter 14 of the Swedish Companies Act, which, in addition to shares and convertible instruments, is one of the security instruments regulated by the Swedish Companies Act.

Structure of the Swedish WISE

The WISE is, in principle, structured so that an investor subscribes for a number of warrants and, in connection with the subscription, the investor pays the full investment amount as payment for the warrants. There is no obligation for the company to repay the investment and hence the investment is treated as equity and not debt on the company's balance sheet. Technically, the warrants do not 'convert' at a specific valuation, but the investor has the right to exercise the warrants to purchase shares in the company. In a future equity financing, the warrants will be exercised by the investors to subscribe for new shares. However, the number of shares each warrant entitles the WISE holder to subscribe for depends on the pre-money valuation in a future equity financing in the company.

The terms of the WISE normally include a maximum valuation cap, that is, the highest valuation at which conversion may occur. It is also common for the terms to include a discount for the WISE holders in relation to the valuation in a future equity financing round, which may make the WISE an attractive alternative to investors.

To provide some protection for the founders and other existing shareholders in relation to dilution, it is also common to include a valuation floor in the terms of the WISE, that is, the lowest valuation to be used when calculating the conversion rate of the warrants. The terms allow the WISE holder to choose to subscribe for the most senior-ranking class of shares in the company.

Under the standard terms, a WISE holder is not entitled to any information rights and investors are not entitled to any board representation. Investors are obligated to adhere to the shareholders' agreement of the company upon exercise of the warrants. The standard terms also include provisions in relation to different exit scenarios.

The general understanding in Sweden is that the payment for warrants issued for financing a company is no different from a tax perspective than financing carried out via a new share issue. However, the tax perspective always needs to be considered when using a WISE.

The future development of SAFE-like instruments in Sweden

Since the WISE was first introduced on the Swedish market, the instrument has been promoted by some of the leading incubators, accelerators and angel networks in Sweden. In our experience, the use of the instrument has increased as an alternative investment instrument, mostly in relation to early-stage angel rounds. Recently, some early-stage venture capital investors have been also showing interest in using the documentation for their investments into Swedish startups.

The initiative to introduce the WISE appears beneficial for the Swedish startup scene and it is a very valuable initiative by StartupTools and Erik Byrenius. However, it remains to be seen whether the documentation will be more widely used across the market. From our perspective, the WISE standard documentation could still be further developed to become more sophisticated to resemble the standard documentation available on other markets. It is possible that the WISE will fill the gap in financing instruments for raising capital in seed financing rounds, but other more standardised terms for non-repayable convertible notes may prove more popular on the market. Regardless of the form of the instrument, it will be beneficial for Swedish startups, their founders and investors to have access to good alternatives to equity financing rounds similar to that provided by SAFEs to early-stage companies in the US.