EDUCATIONAL NOTES TO THE SIMPLE AGREEMENT FOR FUTURE EQUITY (SAFE)
April 2017

The SAFE as investment instrument came into being at the Y Combinator accelerator in Silicon Valley in late 2013. It addressed a number of local concerns that emerged when a relatively high volume of very early stage deals made their way through Y Combinator's process. The volume, need for immediate (seed) funding and the likelihood that all of the companies making it through this program would quickly move to a Series A financing created the need for an instrument that was not common or preferred. At the same time it was an alternative to a convertible loan which until that point in time had been the instrument to deal with early stage opportunities that needed funding fast, but had certain limitations around loan term and interest rates (less of an issue in Canada).

Not long after its launch SAFEs started to get some traction in Canada although local conditions have forced an adaptation of the agreement that is more in line with Canadian practices and regional circumstances. So far, the SAFE has been fairly popular in the Toronto-Kitchener-Waterloo corridor as well as in Vancouver, but less so in Quebec for instance. It is important to note that these regional circumstances make it clear that it would be unwise for any Canadian jurisdiction to copy and paste an American - and come to think of it, a Silicon Valley - SAFE and use it locally.

So while it is tempting to compare a SAFE to a Convertible Loan, there is one crucial difference and that is that a SAFE does not create a debt, it is therefore also referred to as 'Convertible Equity'.

While SAFE is a relatively new instrument it has gained traction quickly, primarily driven by the fact that it only requires one document to close the financing. The SAFE itself is often not longer than 5-10 pages maximum and, as a result has far lower legal cost. The negotiation and execution of a SAFE can thus be done in a relatively short period of time, assuming the company passes the necessary due diligence required by investors. Timing and flexibility are the key deal drivers here.

While there are obvious benefits, it should be noted that the SAFE structure has drawbacks too. Many investors will not like the fact they are stuck in a potentially open ended deal that offers far less protections than a Convertible Loan and in some case may be asked to accept a SAFE as instrument where Common Shares or a Convertible Loan would have made more sense. SAFEs work best in situations where these is a strong level of institutional (VC) interest so that there can be a reduced level of concern about closing a subsequent financing round. SAFEs therefore tend to work best in market conditions where there is strong demand for deals and may not work in certain Canadian areas. So, a level of caution from the investor's side is warranted when evaluating the appropriateness of a SAFE in a given deal situation.

Note also that some variations in terminology have emerged. For instance, 500 Startups used a 'KISS' which stands for 'Keep it Simple Security' and in Canada there has been use of the term 'LEAF' or 'Lean Equity Alternative Financing'. That said, the terms SAFE and Convertible Equity are most commonly used on both sides of the border.

Furthermore it is important to note that as opposed to Common, Preferred and Convertible Loan term sheets there is no separate term sheet for the SAFE. The idea behind the instrument is speed and efficiency and so when a SAFE is used it will be by going to a signed agreement directly. The educational notes here follow the structure of the Canadian SAFE as presented, and the letters and number correspond directly to that agreement.

A - MINIMUM REQUIRED TERMS

A. The business of the Corporation is [Brief Description of Business, for example, "a Waterloo-based developer of mobile solutions"].
This makes it clear what the business the Corporation is active in, in this case we have the example of a mobile software company. The key purpose here is to let the reader know instantly what the business is about and help the reader frame his or her point of reference when assessing the term sheet. In other words, an investor will typically read through the remainder of the SAFE with a certain perspective if he or she knows that the business is a software, medical device, cleantech or biotech company. It is also the opportunity to insert a geographical location that will further help in the full evaluation of the SAFE. The description however can and should be very short.

B. The Corporation is seeking to raise an aggregate of $[Total Financing Amount of Round] from one or more investors during a subscription period of [Number of Days] ending on [Final Date of Financing].
As opposed to the other terms sheets, SAFEs most often have a rolling close and once the company launches its SAFE financing it is not unusual to see a 90-day window in which the company and its prospective investors can wrap up funding. The company can close and collect cheques as it goes during this 90-day period. Note that company and investors can negotiate a shorter or longer rolling close period should they wish to do that.

C. Purchase Amount

This is the central clause in the SAFE, what amount are investors subscribing for? Note that SAFEs much like Convertible Loans are used at the very early stage, often at the concept stage, and therefore the exact dollar amount is not as defined as it is in the case of the other possible term sheets, in particular those for Common and Preferred Shares. A target of the required minimum dollar amount will usually suffice.

D. Valuation Cap

A valuation cap is pretty much the same as the one you will encounter in Convertible Loans. It entitles the holder of a SAFE to convert into equity at the lower of the valuation cap or the price in the subsequent financing. In other words, a 'cap' protects the holder from a valuation that is far higher than would have been the case had they invested their funds as straight equity by way of shares. In a way this embeds a share valuation in a SAFE, which was conceived to avoid any valuation discussion! Note how this also applies to a Convertible Loan.

It is worth mentioning that there are SAFEs that do not not have 'caps' and therefore expose the investor to a conversion at the price of the first equity financing, whatever that is.

Note for Founders: Map out your projected financing cycle based on your business plan by inserting future financing rounds and estimated future valuation points. That way you can assess the appropriate value for a possible cap in your SAFE agreement.

E. Discount Rate

The discount rate effectively provides the bonus the holders get for participating in a convertible equity structure: a discount to the share price at which the SAFE converts. Normally this ranges from 15 to 30% and is determined in a negotiation between the company and the holders. As a general rule, the shorter the term of the convertible note and the less risky the investment, the lower the expected discount.

So to recap, a SAFE comes essentially in three forms:

1. SAFE with Cap, no Discount
2. SAFE with Discount, no Cap
3. SAFE with Cap and Discount (which is the version we are using here)

Note for Founders: Again like mentioned above, map out your projected financing cycle based on your business plan by inserting future financing rounds and estimated future valuation points. By picking some variables for both your 'discount' and 'cap' it will be possible to determine what future and diluted ownership in the company will look like.

F. Defined Terms

The Defined Terms are attached to the SAFE as Schedule A and here we will find a detailed explanation of what each defined term means. If the founders and investor agree to amend this SAFE they will need to ensure that each new material term they introduce is defined herein.

2a. Equity Financing

If there is an Equity Financing before the expiration or termination of the SAFE, the Corporation will automatically issue to the Investor either: (1) a number of Shares sold in the Equity Financing equal to the Purchase Amount divided by the price per share of the Shares, if the pre-money valuation is less than or equal to the Valuation Cap; or (2) a number of shares equal to the Purchase Amount divided by the SAFE Price (Valuation Cap divided by total outstanding shares, less the Discount), if the pre-money valuation is greater than the Valuation Cap.

The first real equity financing (in common or preferred shares, in the US these would almost in all circumstances be preferred) will trigger the conversion of the SAFE in shares. From having a SAFE the holder now becomes an investor and his or her name will show in the share register. It is also important to note that (as opposed to many convertible loans) there is no threshold amount that will trigger this conversion, any equity financing will guarantee that the SAFE holders will convert and become shareholders based on the valuation the company gets in that transaction.

Note that preferred shares issued to the holder may have a liquidation preference that is equal to the original SAFE investment amount, rather than based on the price of the shares issued to the investors in the new preferred equity financing. This means that the liquidation preference for SAFE holders does not exceed the original investment amount, or to put it differently, the SAFE holders will only get a 1x preference.

2b. Liquidity Event

If there is a Liquidity Event before the expiration or termination of the SAFE, the Investor will, at its option, either (i) receive a cash payment equal to the Purchase Amount, or (ii) automatically receive from the Corporation a number of shares equal to the Purchase Amount divided by the Liquidity Price (price determined in the Liquidity Event, less the Discount), if the Investor fails to select the cash option.

There are essentially two liquidity scenarios one can think of. There is a merger or acquisition and there is the listing on a public exchange. In a "Change of Control" scenario

the SAFE holder converts to shares based on the acquisition or merger price which in the case of an acquisition would often lead to a redemption and cash pay-out of these shares or a cash payment equal to SAFE purchased amount. The Investor effectively picks the option that is the most attractive.
The SAFE will automatically convert into common shares the company goes public on any exchange, using the the same formula as is applicable to the merger or acquisition scenario.

2c. Dissolution Event
If there is a Dissolution Event before the SAFE matures, the Corporation will pay the Investor an amount equal to the Purchase Amount.The Purchase Amount will be paid prior and in preference to any distribution of any of the assets of the Corporation to shareholders of the Corporation by reason of their ownership of such shares. If the assets of the Corporation are insufficient to permit the payment then the entire assets of the Corporation available for distribution will be distributed with equal priority and pro rata among the Holders.
It is important to note that as opposed to the Convertible Loan a SAFE holder does not have security rights over the assets of the company. That said, in a dissolution the company has the obligation to distribute any funds to the SAFE holders ahead of any money allocated to the common shareholders, usually the founders. It should be emphasized however that in a scenario like this it is generally unlikely that there would be any funds left to distribute to SAFE holders who while they rank senior to common shareholders, will rank behind the government, employees and trade creditors.

3 and 4 Corporation and Investor Representations
These are fairly standard in any agreement and the same applies to this SAFE where the Corporation and Investor warrant and confirm these for each others benefit.

5. Information Rights
One of the key issues for investors is to understand how they will be kept informed of the Corporation's progress and how they can quickly understand if things are not moving in the right direction and action is warranted. Given the stage where SAFEs are used one would expect that monthly rather than quarterly updates would be most beneficial for the SAFE holders. At the same time the company may be so early or young that it has not yet formalized reporting procedures and that holders may have to be pro-active to get the necessary information out of company's management.
Good Practice: The challenge in this area is that by the time an Investor receives company information most events are well in the past. This in particular is an issue if things are not going in the right direction or certain crises emerge (cash crunch, milestones not met, large

contracts cancelled). Companies often have a habit to under-report bad news and over-report good news. Some companies make use of online reporting tools (e.g. Klipfolio LINK, Hockeystick LINK, Visible LINK) which track the company's key performance in real time and offer easy to understand dashboards that will tell how a company is doing.

It is up to the company and its investors to agree on the best communication tools which will include in-person meetings although it should be noted that company executives will not have the bandwidth to meet individually with each investor on a regular basis.

Note for Founders: A balance has to be found here between what a company can logistically report on a regular basis and what investors want and need to see. Founders may want to set up some systems and processes that will automate information sharing and thus reduce the time spent on this. Most of this information the company will have to prepare for internal purposes anyways. In particular for companies using a SAFE it is likely that give the very early stage no communication protocols are in place.

Note that if an employee exercises his or her share options, they will become a shareholder and be entitled to the same level of access to company information.

From time to time in person meetings with investors will be beneficial for both parties, a party or social event together with the AGM is also recommended.

6. MISCELLANEOUS

Section 6 contains standard miscellaneous conditions, most of which are self-explanatory. That said, there are three that require some further discussion for the benefit of investors and founders.

6f. Governing Law

All rights and obligations hereunder will be governed by the laws of the Province of [Jurisdiction] and the federal laws of Canada applicable therein, without regard to the conflicts of law provisions of such jurisdiction.

This is standard and essential term in which the parties specify that any dispute arising under the term sheet shall be determined in accordance with the law of a particular jurisdiction. For Canadian companies bringing on US or overseas investors it is important to ensure that Canadian law is used, both from a practical and cost perspective.

6h. Confidentiality

The Corporation and the Investor, and any other persons acting on their behalf, shall keep this instrument in strict confidence and shall not use any information or materials for any purpose other than in considering or in connection with the transaction contemplated herein, and shall not issue any public statement

concerning this instrument or the transaction contemplated herein without the other party's prior written approval.

This is a standard confidentiality undertaking which is different from a mutual confidentiality undertaking which the Company and potential Investors may have signed at the outset of their discussion and which will generally deal with all information that the parties disclose while negotiating a potential transaction.

Note for Founders: Investors are increasingly unwilling to sign NDAs and you have to bear this in mind when disclosing company information. VCs have been unwilling to do for many years and angels are just following market practice here. It is however advisable for both parties to ensure that deal terms remain confidential and this close in the SAFE captures exactly that.

6i. Cost and Legal Counsel

Each party will be responsible for its own costs in connection with this instrument and the transaction contemplated herein.

Although in general – and in particular when using a standardized term sheet – companies and investors do not engage with formal counsel until such time a transaction is closed, it is generally advised to make clear who carries whose legal costs. The cost with a SAFE - which is a final agreement - should be minimal.

B - EXTENDED TERMS

B1. Investor (s)

"NAME" and other investors acceptable to the Corporation (collectively the "Investors" and each an "Investor"). The Investors will appoint a single investor to lead the Investment with the Corporation (the "Lead Investor"). The Lead Investor (in consultation with the other Investors) shall finalize the terms of the Investment, as described herein."

In investor-led deals the investors will insert this clause to outline who they are and what specific role they play and what rights they have. Term sheets that are company-led will generally not have this clause, it is therefore largely an optional clause.

B2. Board of Directors

The Corporation's Board of Directors currently consists of two (2) directors. Prior to the completion of the Offering the Board of Directors shall be increased in size to three (3) directors, the investors in the Financing shall appoint one of the three

directors.

Investors will have the right to appoint an Observer.

It is rare to see investors demanding a board position in SAFE or convertible equity financings although in theory it could be possible if the situation required this. In the latter case our general commentary about boards and observers applies.

Good Practice: In most early stage companies and prior to a first round of investment , the original founders usually form the Board of Directors. The first financing offers the opportunity to elect a group of Directors that not only represent the founders, but also other investors and in some case this can be specified and negotiated in a term sheet. It is recommended that investors are satisfied that their interests are sufficiently represented on a Board of Directors.

In general a Board would consist of an uneven number of directors and range in size from anywhere between 3 and 5 directors at the earlier stages of the Corporation. Potential Directors should be aware of Director's liability, Director's compensation (mostly stock options and/or a per meeting fee) and the frequency at which board meetings are held. It will also be important to understand what is expected of directors on an ongoing basis in terms of time commitment and contributions, including managing the expectation of committing further funds.

Most companies will purchase Directors and Officers Insurance ("D&O Insurance) but this would have to be agreed with the new board and the recurring annual cost of it also has to be taken into account.

Investors may also ask to appoint an Observer to board meetings. This person does not have any fiduciary obligations or the right to speak during board meetings. The observer role merely functions as a 'check' on corporate proceedings to see what is going on. In practice observers tend to actively participate in board meetings and that may have some benefits if his or her contributions are productive.

Note for Founders: Ensure that your shareholding is well represented and that the best people on the founding team also take the board seat(s). If the board expands you may want to ensure that someone with an entrepreneurial background joins the board as such a person is often in a far better position to understand how a founder thinks and feels about certain issues. While a governance tool and a venue where other shareholders can be represented, founders should make a board 'work' for the company, it can help a company grow with great ideas, connections and in some cases actually roll up the sleeves and get stuff done. Do remember that non-founder board members will want to see some form of compensation (share options, per meeting fee) in addition to the D&O insurance. If funds are tight you can suffice with share options and an indemnification agreement.

B3. Tax Credits

Depending on jurisdiction, and whether the Corporation qualifies, the Corporation

would insert appropriate language here that outlines its commitment to obtain the relevant tax credits for each eligible investor participating in the Offering.
Example (BC): The Corporation is an Eligible Business Corporation ("EBC") under the terms of the British Columbia "Small Business Venture Capital Act" ("SBVCA") and will apply for a 30% tax investment credit for BC-based investors for investment made up to March 1, 2018.
Note that a SAFE may be eligible for certain provincial tax credits, but this is an emerging area and in each case investors and company will need to investigate this with relevant provincial authorities.

B4. Maturity Date
December 31, 2019
Here is an area where a standard Canadian SAFE diverges from the US original version. A SAFE was designed to expire and terminate only when a holder received equity or cash, and a SAFE could thus be outstanding for a relatively long period of time and add a level of uncertainty for the investor. Now the transaction or deal volume in for instance Silicon Valley almost made it unnecessary to worry about maturity (plus the fact that all deals had been vetted by one of the world's pre-eminent accelerators). Given the different market conditions in Canada it was deemed safe (no pun intended) to suggest to insert a maturity date in order to add some investor protection in a market that lacks the volume of Silicon Valley.
Good Practice and Note for Founders: This clearly is an item that we encourage the founders and investors to negotiate. A maturity date gives investors some more protection and will enable the parties to come to the table and negotiate the next steps if a conversion has not materialized by that pre-agreed maturity date.