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FUND FORMATION & INVESTMENT MANAGEMENT ALERT

SEC STAFF PERMITS SPONSORS TO OPERATE ONLINE PLATFORMS THAT FACILITATE INVESTMENTS IN EARLY STAGE COMPANIES WITHOUT REGISTRATION AS A BROKER-DEALER

In late March 2013, the Securities and Exchange Commission ("SEC") issued two separate "no-action letters" that permitted the sponsors of online platforms utilizing a "venture fund" approach to receive incentive compensation without having to register as a broker-dealer under Section 15(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act").[1]

The JOBS Act contained a provision[2], now codified as Section 4(b) of the Securities Act of 1933, as amended (the "Securities Act"), which exempts trading platforms from broker-dealer registration if they meet several conditions including, without limitation, that the platform (and those persons associated with it) may not: (i) receive compensation in connection with the purchase or sale of a security traded on the platform; (ii) possess customer funds or securities; and (iii) be subject to a "statutory disqualification" under Section 3(a)(39) of the Exchange Act.

Both no-action letters involve online platforms with the following features:

- Information regarding certain early-stage companies identified by the sponsor is posted on the online platform for review by its members, in the nature of a listing or matching service.
- All members that access the platform are required to be accredited investors as defined in Rule 501 of Regulation D and are subject to a waiting period before they are eligible to make investments.
- Once a sufficient level of investor interest is reached, the sponsor forms a single purpose limited liability company, limited partnership or other investment vehicle which is, in turn, funded by the participating investors and, thereafter, makes the investment into the contemplated early-stage company.[3]
- Investors fund the investment vehicles by making payment directly to a custody account subject to Advisers Act Rule 206(4)-2 at a custodian bank or trust company.
- Once the investment is made, the investment vehicle, rather than its individual investors, holds the right to vote and dispose of the interests in its portfolio company, as well as to exercise management rights to the extent applicable.
- The compensation and fee structure for the investment vehicles involve (i) an administrative fee to defray out-of-pocket costs of the fund (such as legal costs for formation, filing fees, bank custody fees, etc.)[4]; and (ii) an allocation to the sponsor of the future profits, if any, realized by the investment vehicle from a disposition of the portfolio company, commonly referred to as "carried interest", as compensation for providing certain investment advisory and/or organizational/administrative/management services to the investment vehicle.[5] The administrative fee and "carried interest" were disclosed to investors at the time of fund formation.

Notably, these no-action letters suggest that receiving compensation in the nature of backend "carried interest" is different in principle than "compensation in connection with the purchase and sale of a security" or "transaction based compensation" based on the amount of funds raised – which are a hallmark of broker-dealer status. More specifically, the SEC appears to view the receipt of backend "carried interest", if any, as being tied to the increase

continued next page

in value of the investment and, therefore, more appropriately regulated under the investment adviser rubric. However, the no-action letters did not address whether a management fee (i.e., an annual fee based on assets under management) would be permissible.

Although the no-action letters' main thrust regarding the lack of broker-dealer registration is essentially the same, less attention is given to how the recipients approached the investment adviser registration requirements under the Investment Advisers Act of 1940 (the "Advisers Act"). In the AngelList no-action letter, the sponsor contemplated becoming a registered investment adviser. However, in the FundersClub no-action letter the sponsor was an "exempt reporting adviser" because it only advised "venture capital funds" as defined by Rule 203(l)-1 promulgated under the Advisers Act.[6] Registered investment advisers are subject to all of the reporting, recordkeeping and compliance obligations under the Advisers Act and cannot receive "performance fees" (such as "carried interest") unless all of the investors are "qualified clients" as defined in Rule 205-3 under the Advisers Act (which is a significantly higher financial threshold than that required to be an accredited investor). On the other hand, an "exempt reporting adviser" is not required to register with the SEC, although it is subject to limited reporting, recordkeeping and other obligations under the Advisors Act.[7] In addition, technically speaking, "exempt reporting advisers" are not subject to the aforementioned performance fee prohibition.[8]

Overall, the two no-action letters add clarity and provide a roadmap for online platforms[9] that utilize a "venture fund" model to engage in capital formation for early-stage companies, while remaining in compliance with broker-dealer and investment adviser registration requirements under federal securities laws. It remains to be seen whether the proposed rules permitting general solicitation in Rule 506 offerings to accredited investor purchasers will end up providing additional traction to the "venture fund" model platform described in the no-action letters, once such rules are promulgated by the SEC.

Placement agents, "finders", and others seeking to operate such online platforms and form investment vehicles along the lines described herein should be careful to structure and operate such platforms and investment vehicles in compliance with applicable federal and state securities laws, as well as current SEC guidance. Sponsors that wish to be treated as an "exempt reporting adviser" should be mindful to structure each individual investment vehicle to fall within the definition of a "venture capital fund"[10] or, alternatively, to structure their operations so that the sponsor can satisfy the "private fund adviser exemption".[11]

This is a rapidly changing area of law and no-action letters are highly fact specific. In addition, the SEC may modify, broaden, narrow or even reverse its current views in subsequent no-action letters or through other interpretive guidance.

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1 AngelList and AngelList Advisors LLC (SEC No-Action Letter), March 28, 2013. See also, FundersClub Inc. and FundersClub Management LLC (SEC No-Action Letter), March 26, 2013.

2 See Section 201(c) of the JOBS Act.

3 The interests in such investment vehicles are offered and sold to investors in accordance with Rule 506 of Regulation D promulgated under the Securities Act, with such investors receiving standardized legal documentation, such as a supplemental memorandum that provides pertinent information about the investment vehicle and a subscription agreement. In addition, such investment vehicles are structured so as to be exempt from registration under the Investment Company Act of 1940, as amended (the "Investment Company Act") pursuant to Section 3(c)(1) or 3(c)(7) thereof.

4 In the AngelList no-action letter, the sponsor provided the initial capital to such vehicles in order to pay for such documented organizational/administrative costs, with such funds to be reimbursed only upon liquidation of the investment vehicle. In the FundersClub no-action letter, the administrative fee was to be paid by investors as a portion of their investment into the investment vehicle, with any remaining amounts being distributed to investors pro-rata upon liquidation of the investment vehicle, and the sponsor represented that they would not receive any part of such administrative fee.

5 In the FundersClub no-action letter, the "carried interest" was anticipated to be 20% of the profits of the investment fund, but never to

continued next page

exceed 30%.

6 Generally speaking, a "venture capital fund" is a private fund that (i) holds no more than 20% of the fund's capital commitments in non-qualifying investments (other than short term holdings); (ii) does not borrow or otherwise incur leverage (other than limited short-term borrowings); (iii) does not offer its investors redemption or other similar liquidity rights, except in extraordinary situations; (iv) represents itself as pursuing venture capital strategy to investors; and (v) is not registered under the Investment Company Act, and has not elected to be treated as a business development company.

7 See Rule 204-4 promulgated under the Advisers Act.

8 See Rule 205-3(c)(2) promulgated under the Advisers Act.

9 The SEC has yet to promulgate rules under the JOBS Act regarding non-accredited investor crowdfunding portals, not to be confused with the online platforms described herein.

10 See Rule 203(l)-1 promulgated under the Advisers Act.

11 See Section 203(m) of the Advisers Act and Rule 203(m)-1 promulgated under the Advisers Act.

We are available to provide counsel concerning these issues, as well as related corporate or securities law issues. For additional information, please contact one of the attorneys named below or the attorney with whom you have a primary relationship.

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