

Securities Alert

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Two Recent SEC No Action Letters Establish Standards for Crowdsourcing Online Platforms Limited to "Accredited Investors" to Avoid Registration as a Broker-Dealer

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In two recent no action letters, the Securities and Exchange Commission (the "SEC") granted no action relief for two venture capital online funding platforms, the FundersClub, Inc. ("FundersClub") and AngelList, LLC ("AngelList"), allowing them to avoid registering as broker-dealers under the Securities Exchange Act of 1934 (the "Exchange Act") even though their affiliates will receive some compensation in the form of a carried interest. The new letters indicate that running a platform that connects investors with private funds and qualifying investors as accredited investors for private placements will not, in and of itself, require broker-dealer registration so long as there are no other broker-dealer indicia like transaction-based compensation or handling of customer funds or securities. The letters also confirm the SEC's position that carried interest compensation for advisory services in a private equity fund, such as a venture capital fund, is not, in and of itself, transaction-based compensation for broker-dealer registration purposes. Significantly, both funding platforms are limited to accredited investors only and the offerings relate to investments in special purpose investment vehicles and not direct investments in the underlying portfolio companies. The no action letters do not provide standards for platforms that may want to provide direct investments into portfolio companies.

The FundersClub Model

FundersClub qualifies potential investors through an "online process." Once an investor's accredited status is confirmed, that investor may access a FundersClub website listing investment opportunities and information provided by various start-up companies seeking investment capital.¹ Upon gaining access to the site, the potential investor may submit nonbinding indications of interests for the various opportunities, and once a certain threshold of investor interest is met, FundersClub will close the indication of interest process for a particular investment opportunity and reconfirm each interested investor's accredited status.

A venture capital investment adviser owned by FundersClub (the "FundersClub Adviser") will then enter into a term sheet with the start-up company. Once an agreement is reached, a private venture capital fund is formed with the FundersClub Adviser as the official investment adviser to the fund and a third-party custodian is retained to take custody of the investor funds. The FundersClub Adviser is granted certain management rights in the start-up company, provides the start-up company with certain planning and strategic advice, may provide the start-up company networking opportunities, and has the right to vote the securities held by the newly formed private fund, including the right to accept or reject any tender offer.

AngelList's Variation on the FundersClub Model: Angel Followed & Angel Advised Deals

AngelList employs a similar strategy, but notably offers two different investment models: the "Angel Followed Deal" and the "Angel Advised Deal." In an Angel Followed Deal, potential investors are able to see when a high-net-worth individual experienced in venture financing (an "Angel") makes certain investments and are permitted to

follow the Angel's lead when making investment decisions. The Angel being followed does not take an active role in providing advice or services to the potential investors and may not even know that he or she is being followed.

In contrast, in an Angel Advised Deal a particular Angel will take an active role in identifying an opportunity and negotiating the related transaction (the "Lead Angel"). The Lead Angel may be required to provide managerial assistance and guidance to the private or start-up company through an agreement between the Lead Angel and the company for a period of time following investment, but a Lead Angel is not permitted to receive compensation for the provision of advisory services to the investors unless that Lead Angel is either registered as an investment adviser itself or exempt from adviser registration requirements under applicable state law and the Investment Advisers Act of 1940 (the "Advisers Act").

Carried Interest Not Compensation in Connection with the Purchase or Sale of Securities Under the Circumstances

A carried interest is compensation paid as a percentage of profits or an increase in investment value when an underlying investment in an investment partnership or vehicle is resold by such investment vehicle. This differs from the transaction-based compensation arrangement traditionally associated with broker-dealers where payment for services is based on value at the time of initial sale or is contingent upon an initial sale being made. An adviser earning a carried interest has an incentive which carries through the life of an investment to ensure that the value at the time an investment is resold or terminated is greater than the value when an investor first invested his or her money. In this way, the interests of an investor and an adviser receiving solely a carried interest are closely aligned—if the investor doesn't profit, neither does the adviser.

In both the AngelList and FundersClub scenarios neither the platform nor the adviser entities² were paid commissions or fees in connection with the operation of their platforms. Instead, AngelList and FundersClub will receive a carried interest in the profits realized when the various investment vehicles are terminated and their profits are distributed to investors. In light of these two no action letters, it seems apparent that investment advisers can set up investment vehicles for accredited investors online and receive a carried interest in such investment vehicles without the need to register as a broker-dealer.

The SEC's findings were based on the particular facts and circumstances underlying each no action letter, but certain facts were either specifically noted by the SEC or common to both scenarios, including the following:

- The adviser entities advising each investment fund were either registered investment advisers under the Advisers Act or exempt from such registration requirements.
- The adviser entities performed services the SEC deemed to be typical of investment advisers and consultants.
- The adviser entities received carried interest in lieu of compensation for their services and no transaction-based compensation was paid to any entity, including the employees, directors, or officers of any entity.
- The amount and terms of the carried interest were fully disclosed to the investors in the appropriate disclosure documents.
- AngelList was permitted to recoup its formation expenses out of its carried interest upon the applicable investment's distribution. The investment amount contributed to the FundersClub investment entities contained an administrative fee portion to be used to defray actual out-of-pocket costs of the fund, but none of the administrative fees were paid to any FundersClub entity or any of their affiliates or principals.
- Neither AngelList nor FundersClub handled any investor securities, and the services of a third-party custodian were used in both cases.
- No associated persons of either entity were subject to statutory disqualification for membership in a self-regulatory organization.
- AngelList and FundersClub did not generally solicit investors outside of their respective online platforms.
- Access to both online platforms was exclusively limited to accredited investors whose

accredited status was verified by the respective platform entity in advance.

- Potential investor letters of interest and requests for information were non-binding on potential investors.

Companies seeking to operate online crowdsourcing platforms should be very careful when designing the compensation and fees structures associated with their related investment vehicles. While these no action letters were largely favorable to these particular online platforms, the SEC retains the flexibility to adjust its treatment of carried interest depending on the facts and circumstances applicable to any current or future online platform.

For more information on these SEC staff positions and the important opportunities they present, please contact the authors or your Mintz Levin attorney.

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Endnotes

¹ According to the FundersClub website, FundersClub will preselect and prescreen a start-up company through a four step due-diligence process involving the company's review and the review by angel investors prior to listing the start-up company's opportunity on its site.

² Nor any of their respective directors, officers, or employees.

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