

LEGAL UPDATE

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“ACCREDITED CROWDFUNDING” PLATFORMS GRANTED NO-ACTION RELIEF BY THE SEC

When Congress enacted the Jumpstart Our Business Startups Act (the “JOBS Act”) last spring, many entrepreneurs were excited that they would soon be able to raise capital through the use of “crowdfunding” – i.e., raising money by seeking small amounts of cash from large numbers of both accredited and non-accredited investors through the Internet. In a break from the traditional requirements for an unregistered, private offering, Title III of the JOBS Act required the U.S. Securities and Exchange Commission (the “SEC”) to adopt rules to implement a new “crowdfunding” registration exemption that would permit issuers to approach these investors using “general solicitations”, such as email blasts, Internet postings and other similarly broad marketing techniques.

Due to investor protection concerns, the legislation also required that such offerings be conducted in accordance with a significant number of other requirements relating to, among other things, the manner of offering the securities, the types of information made available, and the maximum amount raised on an aggregate and a per-investor basis. These requirements, coupled with the fact that the SEC has not yet adopted, or even proposed, rules that make the new “crowdfunding” exemption a reality, have generated accusations that the SEC is hostile to small-business capital formation.¹

However, in a pair of letters that the SEC’s Division of Trading and Markets issued during the last week in March 2013², the SEC granted no-action relief to two

Internet-based platforms that seem to permit a form of “crowdfunding” – at least where the business model is to match a crowd of “accredited investors” with start-up companies. The analysis set forth in the two letters, which were issued to FundersClub, Inc. and AngelList LLC, and certain of their respective affiliates, will allow such platforms to engage in the specific activities described in their inquiries to the SEC without registering as broker dealers in accordance with Section 15(b) of the Securities Exchange Act of 1934.

It is difficult to evaluate the extent to which the letters apply to other similar platforms because the SEC focuses on the particular facts and circumstances described for the two platforms. Nonetheless, the SEC made clear that online platforms that operate in a substantially similar manner to FundersClub and AngelList, and that possess the key characteristics that the SEC identified in its letters, will be allowed to operate without registering as broker dealers.

Among the factors that the SEC noted in particular are that the investment opportunities are available only to “accredited investors”, that the offerings comply with Rule 506 of Regulation D (with no general solicitation outside of the respective online platforms), that a third-party custodian is used to handle investor securities, and that neither the platform sponsor nor any of its affiliates receives any transaction-based compensation. Of particular interest to other potential platform sponsors is the fact that the SEC allowed FundersClub and AngelList to receive incentive compensation for services each provided to the particular investment vehicles in the form of a “carried interest” – acknowledging that such “carried interest” does not constitute transaction-based compensation.

¹ See, “Will the S.E.C. Kill Crowdfunding?”, Forbes Magazine (2/19/2013), <http://www.forbes.com/sites/chancebarnett/2013/02/19/will-the-s-e-c-kill-crowdfunding/>.

² FundersClub Inc. and FundersClub Management LLC (SEC No-Action Letter), March 26, 2013, available here: <http://www.sec.gov/divisions/marketreg/mr-noaction/2013/funders-club-032613-15a1.pdf>, and AngelList LLC and AngelList Advisors LLC (SEC No-Action Letter),

March 28, 2013, available here: <http://www.sec.gov/divisions/marketreg/mr-noaction/2013/angel-list-15a1.pdf>.

DESCRIPTION OF PLATFORMS

Although there are several key differences between the FundersClub platform and the AngelList platform from a structural and strategic standpoint, their core business models for purposes of the SEC's analysis are generally similar. In each case, a wholly-owned subsidiary within the organizational structure of FundersClub or AngelList, as applicable (such entity, the "Advisor"), identifies promising start-up companies in need of capital, and performs due diligence on their business operations. As part of this process, the Advisor forms a wholly-owned subsidiary as an investment vehicle for the sole purpose of investing in the start-up.

Once satisfied with the diligence process, the Advisor makes the investment vehicle, along with information about the start-up (which is provided by the start-up), available to interested investors through its related web-based platform. All members of the web-based platform must be "accredited investors", and their status as such is pre-screened by the Advisor. After reviewing the information posted about the early-stage company, interested investors can submit a non-binding indication of interest to acquire an ownership interest in the investment vehicle that is formed to invest in such company. The offer and sale of interests in the investment vehicle is conducted in accordance with Rule 506 of Regulation D.

If a sufficient amount of interest to proceed with an investment in a particular company is generated, the Advisor will close the investment vehicle, finalize the terms of the investment vehicle's investment in the start-up, and collect subscription agreements from each participating investor. Each participating investor then forwards the purchase price for its interest in the investment vehicle to a custody account at a custodian bank or trust company.

The Advisor provides investment advice and administrative services to the investment vehicle, which includes, among other things, making decisions regarding the voting and disposition of the securities that the investment vehicle holds in the start-up, and exercising any management rights that the investment vehicle possesses with respect thereto. Investors in the investment vehicle do not directly own shares of the start-up company.

In the case of both FundersClub and AngelList, neither the platform operator nor any of its affiliates receives a

commission or management fee as compensation for its services (i.e., there is no transaction-based compensation). However, the Advisor receives incentive compensation in the form of a "carried interest" in profits that only occurs if there is an increase in the value of the investment as calculated at the termination of the investment in the investment vehicle. While AngelList does not provide specifics about the anticipated amount of this "carried interest", the FundersClub letter states that the "carried interest" would be set at an anticipated rate of 20% or less of the profits of the investment vehicle, but never exceeding 30%.

The sponsor is also made whole for certain of the actual costs and expenses incurred in connection with the formation and/or operation of the investment vehicle, with AngelList recouping the formation costs out of its carried interest upon the distribution of the investment vehicle's assets, and with the investment amount contributed to the FundersClub investment vehicles containing an administrative fee to defray actual out-of-pocket costs of the such vehicles.

CONCLUSION

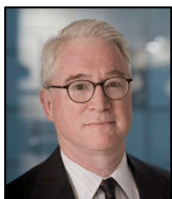
As noted above, the SEC's analysis in the FundersClub and AngelList no-action letters is based on the very specific facts and circumstances of these two platforms, and does not represent a liberalization of the unregistered offering process that many issuers and investors hope will occur as a result of Title III of the JOBS Act. Nonetheless, we believe that the letters will open up new avenues for capital formation, which itself is welcome news for those in the start-up community.

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The foregoing is merely a discussion of the no-action letters described. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Stephen M. Goodman at 212-326-0146 or Michael T. Campoli at 212-326-0468.

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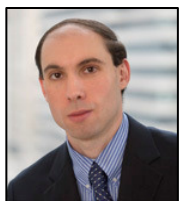
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Mr. Goodman is a 1977 graduate of New York University School of Law, where he was Order of the Coif and Articles Editor of the Annual Survey of American Law.



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