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Investment Portals: Has the Era of Online Venture Capital Begun?

Web technologies are revolutionizing business models and changing the ways in which we interact. The Internet and its millions of websites have transformed the way businesses market their products. This technological revolution is a natural habitat for capital raising; but its development has been fitful, in part, because of regulatory limits. The particular challenge for Internet-based venture capital marketplaces has been that investments are restricted securities under the Securities Act of 1933 (Securities Act), limiting the ability of the funds to solicit investors, and requiring any online venture capital marketplace to prescreen investors.

Recent modifications to the legal framework for capital raising have the potential to expand web-based venture capital markets. The hoped-for result will be one in which deserving companies have access to the capital that they need, and investors obtain access to investment opportunities, without exposing either new companies to unnecessary regulatory burdens or investors to unnecessary risks.

Last year, the JOBS Act[1] expanded opportunities for companies to use technology to raise capital more efficiently by, among other things, relaxing the limitations on solicitation of accredited investors in Regulation D under the Securities Act. The JOBS Act also created a new exception from broker-dealer registration under the Securities Exchange Act of 1934 (Exchange Act) to permit the creation of "funding portals" for introducing new investment opportunities to accredited investors. In recent months, the Staff of the US Securities and Exchange Commission's (SEC) Division of Trading and Markets (Staff) has issued FAQs, as well as two no-action letters, addressing these new portals.

JOBS Act

One of the primary hurdles for any type of capital raising, including online venture capital fund raising, has been the limitation in Regulation D on general solicitations in private placements—because virtually all venture capital fundraising is done in privately placed securities offerings. Another hurdle is the requirement that entities (other than issuers themselves) engaged in capital raising frequently must register as broker-dealers. Historically, a platform that charged any fees

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for providing services would almost invariably be regarded as a broker—"engaged in the business of effecting transactions in securities for the account of others"—and would therefore be subject to Section 15(a) of the Exchange Act, which requires persons who fall within the definition of a broker to become registered with the SEC and also to become members of the Financial Industry Regulatory Authority, Inc. (FINRA).

Section 201 of the JOBS Act is intended to promote the development of new businesses by reducing the costs and delays that companies would encounter in raising capital. Among other things, Section 201 removed the limitations on general solicitation or advertising that applied to issuers relying on the private offering exemption from securities registration in Section 4(2) of the Securities Act and Rule 506 of Regulation D, as long as all purchasers of the securities were accredited investors.[2]

In addition, the JOBS Act sought to reduce the costs that intermediaries would incur when providing companies with access to potential investors. Section 201(c) of the JOBS Act added new paragraph (b) to Section 4 of the Securities Act. This provision states that a person who conducts an offering in compliance with Rule 506 of Regulation D will not be required to register with the SEC as a broker-dealer solely because they maintain an investment platform or engage in general solicitations of securities. Although a person relying on Section 201(c) cannot receive compensation in connection with the purchase or sale of the security, such a person can co-invest in the securities and provide "ancillary services," presumably for a fixed fee not dependent upon the success of a transaction.

Staff FAQs Regarding the Section 201 Exemption

FAQs issued by the SEC Staff in February 2013, indicated that offerors may rely on Section 201 without further SEC rulemaking. The Staff clarified, however, that the exemption from broker-dealer registration only applies when securities are offered and sold under Rule 506 of Regulation D and that issuers will only be permitted to rely on Section 201 to conduct Internet offerings after the SEC adopts new rules permitting general solicitations under Rule 506.[3] The FAQs also noted that transaction-based compensation, compensation paid to internal marketing staff of an adviser, any salary paid to a person for engaging in these activities, or any direct or indirect economic benefit to the person or any of its associated persons in connection with the purchase or sale of securities, were prohibited. Only profits associated with co-investment in the securities would be permissible.[4] The Staff suggested further that, because of the limits on compensation, Section 201 would primarily be used by venture capital firms.

Recent Investment Portal No-Action Letters

Despite the initial guidance provided by the Staff in the FAQs, numerous practical questions about the operation of Section 201 remained unanswered. In March of 2013, however, the Staff issued no-action letters to (i) FundersClub Inc. (FundersClub) and FundersClub Management LLC (FC Management); and (ii) AngelList LLC (AngelList) and AngelList Advisors LLC (AngelList Advisors) providing additional guidance about the scope of services that may be offered by investment portals, without broker-dealer registration.[5] While the letters are not based on Section 201, some of the terms are similar to those found in the statutory exemption and in prior Staff no-action letters.[6] For this reason, they may provide additional insights not contained in the FAQs.

In granting the no-action requests, however, the Staff noted that: (1) the firms were either investment advisers registered under the Investment Advisers Act of 1940 (Advisers Act), or venture capital fund advisers relying on the exemption from investment adviser registration in Advisers Act Rule 203(1)-1; (2) there would be no fees contingent upon the outcome or completion of any securities transaction (compensation would be traditional advisory compensation); (3) the sponsors would not participate in any negotiations between the companies and investors (though they could negotiate with the companies raising funds); (4) the entities would not handle funds or securities involved in completing a

transaction; and (5) the entities would not hold themselves out as providing any securities-related service other than a listing or matching service.

FundersClub

FundersClub and its wholly-owned subsidiary FC Management are advisers to venture capital funds, as defined in Rule 203(1)-1 of the Advisers Act, and therefore exempt from registration as investment advisers. FC Management manages a series of separate investment funds formed to invest in one or more start-up companies and through which it negotiates management rights with the start-up company, and can sell securities of the start-up company in the secondary market.

FundersClub and FC Management identify and undertake due diligence of the start-up companies, set target amounts of capital, and then post information regarding the start-up companies on the FundersClub website. FundersClub members can submit non-binding indications of interest regarding individual companies whose information has been posted on the website. Once a fund has reached a target amount of non-binding indications of interest from potential investors, FundersClub negotiates definitive terms of the investment with the start-up company. FC Management then enters into limited liability company agreements with the investors. Investors remit funds to a custody account subject to Rule 206(4)-2 of the Advisers Act, and the money is then invested in the start-up company.

FundersClub and FC Management will not receive compensation for selling securities. Instead, they are compensated for their work in organizing and managing the investment funds. Their compensation is expected to be 20 percent or less (and is capped at a maximum 30 percent rate) of the profits of the investment fund and FC Management may also charge an administrative fee to defray certain out-of-pocket costs of the investment fund.

AngelList Advisors

AngelList Advisors is a registered investment adviser that functions as a wholly-owned subsidiary of AngelList. AngelList Advisors identifies and approves portfolio companies, potential "angel investors," and a "lead angel investor." Once it has identified and approved a portfolio company and its corresponding lead angel investor, it forms a separate investment vehicle that invests in that portfolio company. AngelList Advisors then makes the investment vehicle available to potential angel investors, and, if sufficient interest is received, it closes the investment vehicle and collects subscription agreements from the participating investors.

AngelList distinguishes between Angel Followed Deals and Angel Advised Deals. In an Angel Followed Deal, the lead angel will not need to take an active role, whereas in an Angel Advised Deal, the lead angel will take an active role in identifying the investment opportunity, leading negotiations, and providing significant managerial assistance and financial guidance.[7] AngelList intends to use both models for its investment portal, and intends to provide investment adviser and administrative services to the investment vehicle. AngelList Advisors will not receive commissions or management fees, but will receive a "carried interest" equal to a portion of the increase in value of the investment.

Common Factors Considered by the SEC Staff

Both of the companies that received no-action letters intend to operate in the venture capital space – though only the FundersClub letter was conditioned on the firm falling within the venture capital firm definition in Rule 203(1)-1 of the Advisers Act. While, as noted above, the services of the firms are generally consistent with the terms of Section 201 of the JOBS Act, as well as the Staff's FAQs, the no-action letters address several areas that have not been defined, including the fact that carried interest will not be perceived as transaction-based or other compensation for purposes of the Section 201 exemption, the range of "ancillary services" that might be offered, and the restrictions on handling funds and securities that may apply. The letters also suggest additional terms the Staff may require for similar relief in the future in instances in which Section 201 is not available.[8]

Conclusion

Further regulatory guidance is expected as entrepreneurs seek to develop new markets and capitalize on opportunities. The JOBS Act, the SEC's FAQs, and the no-action letters all provide opportunities for investment portals to operate without additional regulation. It remains to be seen whether investment portals that are able to operate under the conditions they impose will be successful. Restrictions on the receipt of compensation, and other limitations, ultimately may encourage more mature businesses to register as broker-dealers.

Notes

1. Jumpstart Our Business Startups Act (JOBS Act).

2. *See also* Jumpstart Our Business Startups Act: Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act (Feb. 5, 2013).

3. Regulators have historically been concerned that funding portals would expose investors to fraud and that, therefore, a stringent regulatory regime was necessary. Generally, an issuer may not conduct a general solicitation of a Rule 506 offering; however, on July 10, 2013, the SEC adopted new rules under the JOBS Act to lift the ban on general solicitation or general advertising for certain private securities offerings.

4. *See* Question 8 of the FAQs.

5. AngelList LLC and AngelList Advisors LLC, SEC No-Action Letter (Mar. 28, 2013); FundersClub Inc. and FundersClub Management LLC, SEC No-Action Letter (Mar. 26, 2013).

6. FundersClub stated in its no-action request that it believed its activities were within Section 201, despite its request for no-action relief. In its response, the Staff also noted that FundersClub appeared to be able to rely on Section 201 based on its current activities. AngelList cited Angel Capital Electronic Network, SEC No-Action Letter (Oct. 25, 1996). *See also* Internet Capital Corp., SEC No-Action Letter (Dec. 24, 1997). *Compare*, *In Re SharesPost et. al*, Exchange Act Rel. No. 66594 (Mar. 14, 2012) (SEC enforcement action under Section 15(a) of the Exchange Act against an online service, similar to AngelList and FundersClub, that matched buyers and sellers of pre-IPO shares, but received compensation). Other letters, in which the Staff denied no-action relief include: MuniAuction, Inc., SEC No-Action Letter (Mar. 13, 2000) (finding that a website that ran auctions in the municipal bonds market had to register as a broker-dealer); Progressive Technology Inc., SEC No-Action Letter (Oct. 11, 2000) (requiring broker-dealer registration for a company that operated a website that brought together issuers of securities and investors); BondGlobe, Inc., SEC No-Action Letter (Feb. 6, 2001) (determining that a website that accepted fees for communicating orders, along with other practices such as conducting auctions and reverse auctions constituted broker-dealer activity).

7. In addition, the lead angel must agree to personally invest in at least 20 percent of the opportunity, and make at least 50 percent available to other investors. The lead angel also must be a registered investment adviser or rely on an exemption from registration.

8. Additional structures may be created to facilitate other direct issuances of securities, or secondary market transactions, predicated on conditions outlined in the letters.