Blogs
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Asset Management ADVocate

Two Regulatory Implications of the SEC's Crowdfunding Release

On October 30th, the SEC adopted their Crowdfunding rules and the adopting release became available on October 31st, commonly referred to as Halloween. There are two interesting regulatory decisions in that 686 page release, both of which could be described with one or the other of the customary child's cautionary warning when you answer your front door on Halloween evening. First, the list of issuers eligible to engage in Crowdfunding excludes investment companies as defined in Section 3(a) and investment companies relying on exclusions in Section 3(b) and 3(c) of the Investment Company Act of 1940. It is unclear whether that phraseology was also intended to capture all of the investment companies that rely on the exemptive rules adopted under Section 3, such as Rule 3a-5 (finance subsidiaries), Rule 3a-6 (foreign banks and foreign insurance companies), Rule 3a-7 (issuers of asset-back securities), and Rule 3a-8 (research and development companies). On the one hand, the Commission's decision to exclude investment companies is consistent with the definition of "eligible portfolio company" that is part of the restrictions on business development companies ("BDCs") and on investment advisers to venture capital funds, which preclude them from investing in investment companies and require them, for the most part, to invest directly in start-up operating companies. On the other hand, there is some additional ambiguity in the list of issuers intended to be excluded from those eligible to engaged in Crowdfunding. Specifically, while a BDC is an investment company defined in Section 3(a)(1)(A), it is not actually a registered investment company because it is exempted by Section 6(f) of the Investment Company Act. Although a BDC must be a closed-end fund for it to elect to be a BDC, it might have wanted to have engaged in Crowdfunding and its investment objective would be consistent with the animating purpose behind Crowdfunding. Moreover, like a BDC, an employees' securities company is an investment company as defined in Section 3(a)(1)(A), but an employee securities company relies on an exemption in Section 6(b) -- not Sections 3(b) or 3(c) -- and thus would still seem to be an eligible issuer. Each employees' securities company must, however, be owned by a employing company's employees, not retail investors, and the exemptive order usually issued to an employee securities company pursuant to Section 6(b) could easily be adjusted to preclude use of Crowdfunding to the extent there is any ambiguity about whether it was intended that an employee securities company could be an eligible issuer. Second, one of more bedeviling aspects of Regulation D under the Securities Act of 1933 is the enduring mystery of how shares get sold in a private placement when no one seems to be a registered broker-dealer. In some circles, that would be viewed as a "laugh" line. For a number of years, the ABA Business Law Section has championed the notion of "broker-dealer lite" to describe a level of regulatory investor protection that is more attuned to the actual circumstances that occur during a private placement or similar non-market transaction. During the last several years, there have been several interesting developments along that line. First in time was the no-action letter received by AngelList Advisors LLC that allowed it to avoid registration as a broker-dealer in the context of operating as a registered investment adviser that would not charge transaction-based fees using a website to match up "angels" with potential investment opportunities. Second in time was a speech given by then-Chief Counsel David Blass of the Division of Trading and Markets at the Spring 2013 Meeting of the ABA Business Law Section, in which he forcefully made the case that "finders," both of investors to buy shares in a private equity fund and of investments to be made by the private equity fund, who received transaction-based compensation or success fees were broker-dealers and were required to register. Third in time was the no-enforcement letter that was sent by Mr. Blass to a group of practitioners from the ABA Business Law Section regarding so-called private M&A brokers. Again, the private M&A brokers were allowed to avoid registration as a broker-dealer despite receiving transaction-based compensation so long as they complied with a series of conditions designed to omit from the prevailing circumstances around those transactions various activities that are closely associated with being a

broker-dealer and interacting with retail investors. The last in time, so far, is the decision of the SEC in the Crowdfunding release to require "funding portals" to register as broker-dealers and join FINRA and accept transaction-based compensation, but sharply limit the activities in which they can engage, including prohibiting their officers, directors, and employees from having any financial interest in the issuer being funded although the funding portal itself could receive shares from the issuer as compensation for services rendered. It seems that the pattern to be discerned here is that, in some circumstances, the SEC and its staff can be persuaded that the entire panoply of investor protections that are imposed on the very biggest brokerage firms can be tailored to fit persons engaging in effecting transactions for others and not require registration as a broker-dealer, but not in other circumstances involving retail investors that would raise the customary investor protection concerns.

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