Bloomberg BNA

Securities Regulation & Law Report™

FINANCIAL INSTITUTIONS

5 of the Most Critical Securities Law Questions Facing FinTech Companies



BY ROBERT ROSENBLUM, SUSAN GAULT-BROWN, AND AMY CAIAZZA, PH.D.

FinTech companies are innovators and are in the business of delivering financial services to their clients in new ways. The federal and state securities laws, for the most part, do not contemplate the business practices of FinTech companies, like using websites to sell securities or provide investment advice. As a result, FinTech companies – such as crowdfunding platforms, peer lending platforms, robo-advisers, and virtual currency investment businesses – often face issues of first impression when applying the securities laws to their businesses. Below are five of the most critical securities law questions facing FinTech companies today.

1. Is it a Security and Therefore Subject to Regulation?

The assets a FinTech company holds, sells, or offers can raise difficult questions regarding whether they are or are not securities for purposes of federal and state securities laws. The definition of the term ''security'' under the securities laws is generally very broad, and, in addition to instruments like stocks and bonds also includes catch-all terms like ''investment contract'' and ''evidence of indebtedness.'' Due to the sweeping scope of the definition of a security, instruments that may not first appear to be securities could in fact be deemed to be, and therefore be subject to securities regulation.

Two excellent examples of this issue are bitcoin and loans.

a. Bitcoin

Securities and Exchange Commission Chair Mary Jo White has stated that ''whether a virtual currency is a security under the federal securities laws, and therefore subject to our regulation, is dependent on the particular facts and circumstances at issue.''[1] While the SEC has not made any findings that bitcoin should be treated as a security, we think that if the SEC or its staff undertook such an analysis, they would conduct it under the Supreme Court's *SEC v. W.J. Howey Co.* decision,[2] which analyzes whether particular assets fall within the catch-all security term ''investment contract.'' Under this analysis, an asset is an ''investment contract'' if it involves (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) to be derived solely from the efforts of others. This analysis is very broad and often encompasses assets not otherwise thought to be securities.

---

[1] Letter from Mary Jo White, SEC, to Sen. Thomas R. Carper, Chairman, Committee on Homeland Security and Governmental Affairs (Aug. 30, 2013), at 1.

[2] 328 U.S. 293 (1946).

 ISSN 0037-0665

It is possible that the SEC could evaluate the bitcoin mining process* as a type of common enterprise, with the efforts of miners serving as the requisite ''efforts of others.'' We think, however, that in the bitcoin context, the link between miners and increases in bitcoin value is too remote and speculative, as it does not appear that the efforts of the bitcoin miners has any relation to increases or decreases in the value of bitcoin. It is possible, however, that another type of virtual currency or another type of blockchain product – depending on the design – could fall within the broad category of an investment contract, and therefore fall within SEC jurisdiction.

b. Loans

Many FinTech companies, such as peer lending platforms, regularly engage in activities involving loans. Loans, which are typically evidenced by a note, fall within one of the categories in the security definition – a note. However, under the Supreme Court's analysis in *Reves v. Ernst & Young*,[3] many categories of loans, including mortgage loans and commercial loans, are not treated as securities. In addition, loans that primarily serve a commercial purpose, rather than an investment purpose, generally are not treated as securities. As a result, under the Securities Act of 1933 (Securities Act) and Securities Exchange Act of 1934 (Exchange Act), loans typically are not subject to securities regulation, unless they have characteristics of an investment. However, because of the investment characteristics that exist when loans are pooled together or when advice about loan investments is given, loans either are or may be treated as securities under the Investment Company Act of 1940 and Investment Advisers Act of 1940. Therefore, FinTech companies that hold, sell, or offer loans must evaluate the status of the loans as securities and whether their activities with respect to the loans implicate the broader application of the securities laws.

2. Is Broker-Dealer Registration Required?

The Exchange Act broadly defines the term ''broker'' to mean anyone who engages in the business of effecting securities transactions for the account of others, and defines the term ''dealer'' to mean anyone engaged in the business of buying and selling securities for their own account.[4] To the extent that FinTech companies, such as crowdfunding platforms and peer lending platforms, facilitate the purchase and sale of securities (which as noted above, may include assets like blockchain products or loans, or more conventional assets like interests in private companies or private funds), their activities may implicate broker-dealer registration and regulation. This is particularly the case if the FinTech company receives transaction-based compensation, such as commissions, or maintains custody of securities or funds used to purchase securities. Broker-dealers, unless exempt, must register with the SEC, become members of FINRA, and register in states in which they conduct their activities. Registration as a broker-dealer typically is both costly and time-consuming and, as a result, is not favored by most start-up FinTech companies unless central to their business model. Instead, other avenues, such as investment adviser registration, may be available and should be explored.

* The decentralized bitcoin network collects all transactions from a set period of time into a block. Before the new block of transactions is added to the blockchain (i.e., the general ledger for the bitcoin network), the transactions are put through a verification process by bitcoin miners. Using specialized computer hardware and software, the miners take the information in the block and apply complex mathematical formulas to it. Miners compete with each other to complete the verification process. When a miner successfully verifies a block, the miner receives a fixed number of newly created bitcoin, and the blockchain is updated with the newly verified block.

[3] 494 U.S. 56, 65 (1990).

[4] Exchange Act Sections 3(a)(4) and 3(a)(5).

3. Is Investment Adviser Registration Required?

If a FinTech company provides advice about securities, it may fall within the definition of an ''investment adviser'' under either the federal Investment Advisers Act or similar state laws. A FinTech company may provide advice to website users about which investments to make or how to allocate funds among investments or may provide advice to private funds or special purpose vehicles that are offered through a website. These activities may require registration as an investment adviser with either the SEC or one or more states, or may require an entity to file a report as an exempt reporting adviser with the SEC or one or more states.

Because investment adviser or exempt reporting adviser registration is less costly and time-consuming as compared to broker-dealer registration, many start-up FinTech companies, particularly accredited investor crowdfunding platforms, choose a business model that uses an exempt reporting adviser to manage a series of single-investment special purpose vehicles. Under this model, investors invest in one underlying private company, one real estate investment, or one other investment asset through the single-investment special purpose vehicle. This model allows the entity that manages the special purpose vehicle to file as an exempt reporting adviser (assuming it meets the requirements of Rule 203(l)-1 or Rule 203(m)-1 under the Advisers Act or similar state law)[5] and is permitted to receive management and/or performance-based fees. Importantly, the entity that manages the special purpose vehicle is not required to register as a broker-dealer in connection with its activities by virtue of a SEC no-action letter issued to AngelList LLC in 2013.[6] Many accredited investor crowdfunding platforms currently operate under this model.[7]

[5] These rules apply to venture capital fund advisers and private fund advisers with under $150 million under management, respectively.

[6] AngelList LLC, SEC Staff No-Action Letter (Mar. 28, 2013).

[7] We note that retail crowdfunding platforms cannot use this model, because they are not allowed to offer investments in private funds. See Securities Act Section 4A(f)(3).

   ISSN 0037-0665

Because investment adviser or exempt reporting adviser registration is less costly and time-consuming as compared to broker-dealer registration, many start-up FinTech companies, particularly accredited investor crowdfunding platforms, choose a business model that uses an exempt reporting adviser to manage a series of single-investment special purpose vehicles.

Other types of FinTech companies wrestle with different issues involving investment adviser registration. For example, many FinTech companies present customers with services based on investment-related algorithms. Such services in some cases constitute investment advice. This is true, for example, in the case of so-called robo-advisers. However, other FinTech companies offer services that may not constitute investment advice under a series of SEC no-action letters that apply to technology services.[8] Alternatively, some companies may offer investment services that are exempt from investment adviser registration under the SEC's decision in *SEC v. Lowe*,[9] which applies to publications that contain investment advice that is not tailored to the specific needs of a particular investor. The analysis of whether investment adviser regulation applies to such situations is generally a fact-intensive inquiry.

4. Is Investment Company Registration Required?

Generally speaking, an ''investment company,'' as defined under the Investment Company Act, is an entity that holds at least 40% of its total assets in investment securities. Obviously, mutual funds, ETFs, and private investment funds (like venture capital funds) fit this description. Less obvious are entities that hold assets that are not treated as securities for many purposes—but are for purposes of the Investment Company Act. As noted above, one such asset class is loans. Absent an exception or exemption, an entity that holds over 40% of its total assets in loans may be considered an investment company and may be subject to registration as such. A FinTech company that finds itself in this situation—like many peer lending companies – may be able to avail itself of one of several exceptions that apply to companies that hold loans. For example, Section 3(c)(5)(C) of the Investment Company Act applies to entities that are primarily engaged in holding mortgages and other interests in real estate, Section 3(c)(5)(B) of the Investment Company Act applies to entities that are primarily engaged in making loans to manufacturers, wholesalers, and retailers of specified merchandise, insurance, and services, and Section 3(c)(4) of the Investment Company Act applies to entities substantially all of whose business is confined to make small loans. In addition, depending on a FinTech company's corporate structure, it or one of its affiliates may be able to take advantage of the exceptions available for private funds (Sections 3(c)(1) and 3(c)(7)). Each of these exceptions has its own requirements and may require specific structuring to ensure compliance.

5. Should We Try to Go Out to Retail Investors?

Many FinTech companies – particularly crowdfunding platforms and peer lending platforms—have grown up in an accredited investor environment, relying on Regulation D under the Securities Act to reach wealthy investors.[10] Under Rule 506(c) under Regulation D, these companies can choose to engage in a general solicitation and open their websites up to all interested users, including retail investors, provided that investments can only be made by accredited investors. Accredited investors include natural persons that earn at least $200,000 in each of the two most recent years, and natural persons with over $1 million net worth (not including the value of their primary residence). Many FinTech companies now are asking whether to open investments up to retail investors by facilitating offerings under the new Regulation A+ or the newer Regulation Crowdfunding.

Under Regulation A+, certain smaller companies may take advantage of a streamlined registration process to offer their securities to non-accredited investors. Under Regulation Crowdfunding, companies may offer securities to non-accredited investors through transactions facilitated by registered broker-dealers or funding portals, subject to certain investment limits by individual investors, caps on the amount of money an issuer can raise, and disclosure requirements. Both of these new sets of regulations have their own drawbacks, which in many cases may mean that the right answer for a FinTech company is to stick with Regulation D offerings.

However, there are cases in which Reg A+ and Reg Crowdfunding offerings (''A+/Crowdfunding'') may make sense. For example, there may be cases where a company wishes to offer side-by-side Reg D and A+/Crowdfunding offerings. In such a case, the company would turn to accredited investors to raise the bulk of

[8] *See, e.g.*, EJV Partners, LP, SEC Staff No-Action Letter (Dec. 7, 1992) (providing relief to a provider a computer service offering calculations and pricing models, based on factors that included the sophistication of the users, the degree to which the users themselves perform the calculations, the degree to which the product is pre-packaged and not personalized for each customer, and whether the calculations or models are based on traditional or standard calculations); Charles Street Securities, Inc., SEC Staff No-Action Letter (Feb. 27, 1987) (stating that information relating to securities does not constitute an analysis or report requiring registration as an adviser ''if (1) the information provided is readily available to the public in its raw state; (2) the categories of information are not highly selective and (3) the information is not organized or presented in a manner that suggests the purchase, holding or sale of any securities.''

[9] 472 U.S. 181 (1985).

[10] Notably, two peer lending companies—LendingClub and Prosper – offer their payment dependent notes to the public and do not rely on Regulation D.

its capital, but would try to include its non-accredited customers or supporters through either a Reg A+ or Reg Crowdfunding offering. Both Reg A+ and Regulation Crowdfunding permit such side-by-side offers. Ultimately, the decision to facilitate offerings outside of Reg D offerings is specific to the business model of each FinTech company.

   ISSN 0037-0665

   ISSN 0037-0665