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5 New Year's Resolutions For The SEC

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Happy New Year, SEC! No doubt, right now you are making a list of New Year's resolutions that are easy to implement, and that would promote capital formation without jeopardizing investor protection. Here are five suggestions, in case some of these didn't happen to already make your list.


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Regulatory Simplification for Offerings to Accredited Investors

An "accredited investor" is a person who, by virtue of her wealth or financial sophistication, is able to "fend for herself" when making investment decisions.[1] She can therefore participate in Regulation D private placements and other private offerings without the need for the protection afforded by the registration and many other provisions of the federal securities laws.[2] Implicit in an investor's status as an accredited investor is the concept that the investor is able to identify, understand and accept the risks and conflicts of interest inherent in each offering in which she participates. In several important instances, however, the U.S. Securities and Exchange Commission and its staff have taken positions that in effect seek to protect accredited investors from precisely the investment risks and conflicts that Congress, the courts and the SEC have determined are appropriately left to the judgment of those investors. This year, the SEC should resolve to address at least one of these:

Resolution #1: Re-institute a Limited "Finder's Exemption" with Respect to Accredited Investors

Resolved: A finder that introduces accredited investors to a private issuer, and receives transaction-based compensation, should not be required to register as a broker-dealer.

Discussion: Prior to March of 2000, the SEC staff recognized a "finder's exemption" from broker-dealer registration. The gist of that exemption was that a person who, not as part of a regular business, introduced a buyer and seller of securities, could get paid based on the amount of securities sold (so-called "transaction-based compensation"). A finder generally could not handle money or securities, and could not be actively engaged in negotiating the price or terms of the transaction. In March of 2000, the SEC staff issued a no-action letter rescinding the finder's exemption.[3] This was done without the benefit of notice and comment, without any apparent cost-benefit analysis or economic studies, and without any significant analysis of whether and how this action meaningfully aided in the protection of investors.

Finders who act on behalf of a private issuer clearly perform a valuable capital-formation function.[4] At a minimum, the issuer would not be willing to pay the finder unless the issuer (and its principals) were convinced that the finder's activities were valuable. The SEC's concern, however, is that such a finder has a "salesman's stake" in the transaction, and the finder therefore is incentivized to (for example) use high-pressure sales tactics that can disadvantage the investor.[5]

This concern, though, does not seem to be fundamentally different from other risks and conflicts of interest an accredited investor must consider in almost any private offering. For example, an accredited investor in a private offering must consider whether and how the self-interest of the issuer and its principals affect the presentation in the offering materials of the market and investment opportunity.[6] The accredited investor also must consider how the issuer will use the proceeds of the offering, which in almost all cases will at least include helping to pay for salaries and expenses of the issuer's employees, and may include payments to other service providers and to other investors. The federal (and state) securities laws leave the evaluation of these types of issues to the accredited investor's judgment; it is difficult to see why the comparable issues posed by a finder's potential receipt of transaction-based compensation should be treated differently — i.e., other than through disclosure.[7]

In addition, the SEC's "solution" to the perceived risk posed by finders amounts to massive regulatory overkill.[8] A person who wants to act as a finder must, at a minimum: study for, take and pass a series 7 and other Financial Industry Regulatory Authority exams, which cover large amounts of material that have nothing to do with the proposed finder activities; find and become employed and supervised by a registered broker-dealer — and typically share a portion of her compensation with the broker-dealer — even though that broker-dealer may not have had any role in the finder's activities; and learn about and become subject to the full panoply of FINRA's regulations governing registered representatives, even though most of those regulations have nothing to do with the proposed finder activities.[9]

Not surprisingly, when presented with the herculean task of becoming a registered representative — when the sum total of the proposed finder activities may be to make a few phone calls and send a few emails — many people simply decline to make introductions (to the potential detriment of both the issuer and the investor); others go through significant contortions to avoid being deemed to be a finder and to avoid receiving transaction-based compensation or other compensation tied to introduction services; and at least some others ignore the SEC's views and simply provide the services and receive transaction-based compensation anyway.[10]

The SEC and its staff could (and should) develop an approach that would permit some finders to receive transaction-based compensation without requiring broker-dealer registration.[11] For example, broker-dealer registration arguably is not needed if: (a) the purchaser is an accredited investor who is fully informed of the finder's role and right to receive compensation; (b) the transaction-based compensation is paid by the issuer, and not by the investor (i.e., every dollar invested by the buyer is used to purchase securities, and not to pay the finder); (c) all disclosure information about the offering is provided to the investor by the issuer or its representatives, and not by the finder; (d) the finder does not handle customer money or securities; (e) the finder does not solicit investors through a general solicitation; and (f) the finder is not subject to a "bad actor" disqualification.

Regulatory Simplification for Crowdfunding and Peer Lending Platforms

The past few years have seen an explosion of crowdfunding, peer lending and other Web-based platforms that permit accredited investors to, in effect, finance private companies through equity, debt, loan, bitcoin and other financing arrangements. Congress facilitated the creation and operation of these platforms when it enacted the Jobs Act.[12] The SEC and its staff further assisted this industry by, among other things, issuing rules permitting general solicitations in private placements and issuing several important no-action letters.[13]

There also are several notable “secondary trading” platforms that permit accredited investors to buy and sell shares of private companies. More are likely on the way: Congress recently enacted legislation expressly authorizing secondary sales of private company shares among accredited investors.[14]

Nonetheless, there are still a number of SEC rules and positions that impede the valuable capital-formation, liquidity and price-discovery functions these and similar platforms can provide, without providing any significant investor protections. Here are two resolutions the SEC can make to address some of these issues in 2016:

Resolution #2: Provide Testimonial Relief for Registered Advisers on Accredited Investor-Only Crowdfunding, Peer Lending and Similar Platforms

Resolved: Registered advisers should be able to maintain chat rooms and similar discussion boards on their Web-based platforms.

Discussion: Want to find out if a restaurant is any good? Odds are you will look at reviews on Yelp or another online source. Want to buy a new computer, or car, or a new game for your iPhone, or almost anything else? Odds are you will review comments from users on some online forum.

Want to discuss with other clients of your investment adviser the adviser’s recommendations, suggestions or analysis? You are probably out of luck. Under the SEC’s interpretation of the so-called testimonial rule[15] — a rule that prohibits registered investment advisers from using client testimonials for advertising purposes — a registered adviser cannot maintain and operate such a platform.[16]

There is a good argument that the testimonial rule has outlived its usefulness in all or most circumstances — after all, broker-dealers and other financial intermediaries can and do use testimonials (and unlike investment advisers, they do not owe fiduciary duties to their clients). In addition, the world of “crowd-sourced” reviews has made users aware of their strengths and weaknesses. In any event, the SEC should permit registered advisers who maintain crowdfunding, peer lending and similar online platforms to also include chat or discussion rooms on those platforms.

First, it is not at all clear that a chat room should be viewed as a testimonial (after all, investors can say bad things about the adviser). In any event, crowdfunding, peer lending and similar platforms often provide investors with various investment choices, and the ability for investors to discuss the pros and cons of those different investment opportunities could be very valuable. In today’s online world, it also is odd to investors to not have that functionality. And, in most cases the only entity that can create such a chat room will be the platform’s investment adviser (or an affiliate). Finally, the only investors who can make investments in the opportunities discussed in such a chat room are accredited investors, who (as discussed above) ought to be viewed as being able to navigate a chat room and still make an informed investment decision.[17]

The SEC and its staff could (and should) interpret the testimonial rule to not apply to a chat room or similar feature of an online platform hosted by a registered adviser or an affiliated person if: (a) the purpose of the chat room is to permit investors and potential investors to discuss and comment on investment opportunities that are presented on that site, and (if appropriate) for the adviser to interact with those commenters; (b) only accredited investors may participate in the investment opportunities presented on the site; and (c) all comments are visible to all users of the chat room, except that the investment adviser may remove or edit content solely for abusive or inappropriate language.

Resolution #3: Allow Secondary Trading Platforms for Interests in Continuously Offered Private Funds That Make Periodic Repurchase Offers

Resolved: A private fund whose interests are continuously offered, and that periodically makes repurchase offers to its investors, should be permitted to also maintain a secondary trading market that permits accredited investors to buy and sell the fund's interests.

Discussion: There likely will be an important, and potentially beneficial, intersection among crowdfunding and peer lending platforms, private funds and secondary trading platforms. Many sponsors of various platforms are forming, or are considering forming, private funds that will invest in some or all of the opportunities presented on those platforms. These "permanent capital vehicles" serve many purposes: among those are to provide more certain financing to issuers or borrowers seeking to raise money on the platform, and to permit investors on the platform to participate in a diversified pool of investments without the time and burden of (and potentially at a lower cost than) making each of those investments directly through the platform.

The investments held by such a fund typically will be illiquid, so the fund will not be able to offer periodic redemptions (like a hedge fund). On the other hand, investors in those funds need some form of liquidity. One option would be to mimic the structure of a traditional venture capital or private equity fund, and have a fund raise money during a defined offering period, and terminate and distribute all proceeds after a set investment period. Disadvantages of this approach, though, include that the fund cannot continuously offer interests to new investors, and therefore the fund will eventually run out of money to make new investments. The sponsor can create new funds after the first fund is largely invested (and some sponsors may do this), although there are regulatory and operational concerns with this type of approach.[18]

Another approach — and one that is increasingly popular — is to create a private fund that has a perpetual life, that continuously takes in new investors, and that periodically offers to repurchase a portion of its interests, such as when it has sufficient cash available from new investors or from earnings from portfolio investments. Typically, interests will be purchased and sold based on the fund's net asset value.[19]

The next step in the evolution of these funds is to set up a platform that permits investors to sell their fund interests to other accredited investors. These transactions would generally be expected to take place at a price less than net asset value. Purchasers would benefit because they might be able to purchase fund interests at a discount. Sellers would benefit because they could obtain liquidity even when the fund was unable to conduct a repurchase, or when the size of the repurchase would not permit them to fully liquidate their fund interests. The fund and the remaining fund investors would benefit because the fund would not need to use cash to redeem some investors, and therefore potentially could use that cash for investment purposes.

Despite the apparent win-win-win nature of this approach, the use of a secondary trading platform may cause the fund to violate Regulation M under the Securities Exchange Act of 1934. In general, Regulation M prohibits an issuer (and its affiliates) from purchasing its securities at the same time as it is engaged in a "distribution" of those securities. The term "distribution" is defined broadly and can include private placements under Regulation D.[20] As a result, if a fund described above were deemed to have made a distribution of its securities, it would be subject to Regulation M.

Fortunately, Regulation M permits "redemptions" by (among others) "limited partnerships, at a price based on net asset value, which are effected in accordance with the terms and conditions of the instruments governing the securities ...."[21] Assuming that repurchase offers constitute "redemptions" for purposes of Regulation M (and assuming funds organized as limited liability companies and in other nonpartnership forms also can rely on this rule), a fund that only offered and repurchased interests at net asset value would not have a Regulation M concern.

Unfortunately, Regulation M does not permit redemptions by a limited partnership if the partnership's interests are "traded on a securities exchange, or through an inter-dealer quotation system or electronics communications network."[22] Suffice to say that the definitions of securities exchange and electronics communications network are sufficiently broad to at least raise an issue as to whether an Internet-based, secondary-market trading platform for private fund interests could qualify.

Regulation M is intended to "preclude manipulative conduct by persons with an interest in the outcome of an offering," in light of the fact that those participating may have special opportunities and incentives for manipulation.[23] In the case of a private fund that makes continuous offers and periodic repurchase offers, in all cases at net asset value, and whose sponsor (or other person) maintains a secondary trading platform that provides additional liquidity options for buyers and sellers, there is little or no opportunity for manipulation or other improper conduct by or on behalf of the issuer.[24] There is no reasonable justification for interpreting Regulation M so that it has the effect of outlawing secondary trading systems of this type, especially given the valuable liquidity and price discovery benefits those systems can provide.

The SEC and its staff could (and should) interpret Rule 102 of Regulation M to not apply to a private fund (and its affiliates) when: (a) the private fund continuously offers its interests, and periodically repurchases its interests, at net asset value; (b) the fund or its affiliates make available to fund investors the opportunity to buy and sell their interests on a secondary trading platform, which may be sponsored by an affiliated person of the fund; (c) transactions on the secondary platform may occur at prices other than net asset value; and (d) only accredited investors may participate in trades on the secondary platform.

Regulatory Simplification for Venture Capital Funds

Venture capital and similar private funds play an important role in financing private companies, and they often offer valuable business, strategic and other advice and introductions to private companies and entrepreneurs. Unlike some other private funds, they also pose virtually no systemic risk, in large part because they typically do not borrow money, use swaps, margin or loan securities, or otherwise engage in leveraged activities that pose meaningful financial risks to people and institutions that are not their investors.[25] Some SEC rules and interpretations unnecessarily restrict efficient ways in which venture funds can be structured and operated; here is one resolution the SEC can make to address such an issue this year:

Resolution #4: Provide Master-Feeder Relief for Venture Funds

Resolved: A "master fund" that engages in a venture capital strategy should be able to have one (or more) feeder funds that rely on the 100-person test and one (or more) feeder funds that rely on the qualified-purchaser test.

Discussion: Like many other private funds, venture funds generally rely on one of two tests to avoid having to register as an investment company. Under the 100-person test in Section 3(c)(1) of the Investment Company Act, a fund is not required to register as an investment company if it does not make a public offering and has no more than 100 beneficial owners of its securities. Under the qualified purchaser test in Section 3(c)(7) of the Investment Company Act, a fund is not required to register as an investment company if it does not make a public offering and each of its investors is, in general, an individual with $5 million in investments or an entity with $25 million in investments.

It is perfectly permissible for a 100-person fund and a qualified-purchaser fund to invest side by side, and to have identical portfolio investments.[26] For many venture funds, however, this side-by-side arrangement is a problem. In many cases the issuer of securities would prefer to have one rather than two investors, and often the 100-person fund may be able to make only a relatively small investment in any single issuer (as compared to a qualified purchaser fund),[27] which in some cases may make the 100-person fund an unattractive investor to an issuer. In addition, operating two identical funds can lead to duplicative efforts and costs.

An obvious solution to this issue would be to create a so-called "master feeder" structure, in which a single master fund makes all portfolio investments, and two feeder funds — one relying on the 100-person test and the other relying on the qualified-purchaser test — raise money from investors and contribute all or substantially all of their money to the master fund for investment. The master fund would be able to make a single investment on behalf of both the 100-person fund and the qualified-purchaser fund, leading to happier issuers and likely cost savings for the funds and their investors. Also, because venture funds typically do not permit new investors to invest after the fund's closing, and typically do not permit investors to redeem or otherwise withdraw their investments, there is no realistic chance that significant new investments or redemptions by qualified purchasers in the qualified-purchaser fund could have an adverse effect on the accredited investors in the 100-person fund.

Through a quirk in the Investment Company Act, however, this master-feeder structure does not work — essentially, the problem is that the master fund has no Investment Company Act exemption on which it can rely.[28] Whatever the merit of this result in other private fund contexts, where perhaps significant ongoing investments and redemptions in the qualified-purchaser feeder fund could have adverse effects on the accredited investors in the 100-person feeder fund, there is no comparable risk or other obvious concern in the venture fund context.

The SEC and its staff could (and should) permit a private fund acting as a master fund in a master-feeder structure to not register under the Investment Company Act if: (a) the master fund pursues a venture capital strategy; (b) there are at least two private funds, which act as feeder funds, that invest all or substantially all of their assets in the master fund; (c) at least one feeder fund is excepted from investment company registration under the 100-person test (Section 3(c)(1)) and at least one feeder fund is excepted from investment company registration under the qualified purchaser test (Section 3(c)(7)); (d) after the conclusion of an offering period, the master fund and each feeder fund generally do not accept new investments; and (e) the master fund and each feeder fund generally do not permit investors, at their election, to redeem their interests or otherwise withdraw their invested capital.

Regulatory Simplification Under the Investment Company Act of 1940

Private and public companies often need to obtain “unqualified” opinions that they are not investment companies — such as when they seek to raise money in public offerings or from banks. For a law firm to issue such an unqualified opinion, the company typically must have less than 40 percent of its assets (by value) in the form of investment securities.[29] This test, which in its basic form has been part of the Investment Company Act since its enactment in 1940, now suffers from several significant limitations.

Two of these limitations particularly affect technology and other companies that have limited “hard assets,” but that hold very valuable internally generated patents and other intellectual property that is not recognized as an asset for Generally accepted accounting principles (GAAP) purposes.

First, such a company, which may have a high enterprise valuation or market capitalization, may nonetheless fail the 40 percent test if it makes even modest securities investments, due to its relatively small “asset” base. This is not based on a considered judgment by Congress (or the SEC) that technology companies look like mutual funds; it is an unintended consequence of the fact that, when the statute was enacted 75 years ago, operating companies typically held significant amounts of land, property, equipment, inventory and similar “hard assets.” No one foresaw the highly valuable but “asset-light” technology companies that exist today, and therefore the statute simply doesn’t account for them.

Second, such a company also may be limited in the cash management instruments in which it can invest its cash — in general, cash management instruments other than cash, U.S. government securities and shares of money market mutual funds are or may be investment securities (or “bad assets” for purposes of the 40 percent test).[30] As a result, many of these companies are limited in their ability to invest in instruments such as investment-grade commercial paper, investment-grade short-term corporate debt, and investment-grade municipal securities.[31]

Happily, the SEC can resolve to address both of these issues in 2016:

Resolution #5: Create an Alternative Investment Company Act Status Test For Technology Companies

Resolved: As an alternative to current tests, companies should be able to determine their investment company status based on market capitalization, rather than based on total assets.

Discussion: The original rational of the 40 percent test was compelling, if not particularly principled: apparently, SEC staffers reviewed the financial disclosures of all public companies in the late 1930s, decided which ones they thought were investment companies and which ones they thought were operating companies, and came up with a financial measure that generally differentiated between the two.[32] That financial measure was the 40 percent test.

As discussed above, the 40 percent test simply does not work well for many technology and certain other “asset-light” companies. The basic concept of the test is sound — when is a company’s value so substantially dependent upon its investment holdings that the company’s investors should have the protections of the Investment Company Act? Asset-light companies should be able to make this determination, though, by comparing the value of their investment securities to their enterprise value or market capitalization, rather than to their total assets. So, for example, a private company could be deemed not to be an investment company if the value of its investment securities accounts for no more than 25 percent of its enterprise value (based on the valuation assigned to it in its most recent financing round). Similarly, a public company could be deemed to not be an investment company if the value of its investment securities accounted for no more than 25 percent of its market capitalization as of the end of the preceding calendar quarter.

The “25 percent” figure in the proposed tests above may be too low or too high. It seems like a reasonable minimum figure though; it would seem odd to conclude that a company is an investment company, and that its investors need the protections of the Investment Company Act, when the company derives at least 75 percent of its value from sources and activities other than investments.

This test should significantly address both issues discussed above. First, by looking at enterprise value or market capitalization, the test implicitly includes the value of the company’s internally generated intellectual property, but does so in a way that largely prevents the company from assigning subjective and potentially self-serving valuations to that intellectual property. Second, by allowing an asset-light company to include the value of its intellectual property in the test, the company should have the ability to make additional cash-management investments without being deemed to be an investment company.

The SEC and its staff could (and should) adopt a rule or interpretation that excepts from the definition of investment company an issuer that: (a) engages, directly or through majority-owned or primarily controlled subsidiaries, in one or more noninvestment company businesses; and (b) holds no more than 25 percent of the total value of its enterprise value in “investment securities,” as defined in Section 3(a)(2) of the Investment Company Act. For purposes of this test, enterprise value shall mean: (i) for a company whose common stock is publicly traded, the company’s market capitalization as of the end of the preceding calendar quarter; and (ii) for a company whose common stock is not publicly traded, the valuation assigned to the company based on its most recent financing round involving the sale of equity or equity-related securities. This test would be calculated as of the end of each calendar quarter.

—By Robert Rosenblum, Susan Gault-Brown and Amy Caiazza, Wilson Sonsini Goodrich & Rosati PC

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[1] SEC, Net Worth Standards for Accredited Investors, 76 Federal Register 81794, 81797 (Dec. 29, 2011). See also Rule 501(a) of Regulation D (defining the term “accredited investor”).

[2] The staff recently released a report requesting comment on whether and how the definition of accredited investor should be updated. Staff of the SEC, Report on the Review of the Definition of “Accredited Investor,” http://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf (Dec. 18, 2015).

[3] Dominion Resources, Inc., SEC Staff No-Action Letter (Mar. 7, 2000) (rescinding prior no-action relief for a company that would assist issuers in structuring and issuing securities transactions for a fee contingent on successful closings). See also Brumberg Mackey & Wall PLC, SEC Staff No-Action Letter (May 17, 2010) (rejecting no-action relief for a law firm that would assist a company in finding investors and be paid a portion of the funding raised);

[4] Finders also can provide a valuable liquidity function, and can contribute to price discovery, when they find buyers or sellers in a secondary transaction.

[5] Brumberg, Mackey & Wall (stating that transaction-based compensation "would give [the firm] a "salesman's stake" in the proposed transactions and would create heightened incentive for [the firm] to engage in sales efforts"). See also 1st Global Inc., SEC Staff No-Action Letter (May 7, 2001) (stating that "registration helps to ensure that persons with a 'salesman's stake' in a securities transaction operate in a manner consistent with customer protection standards governing broker-dealers and their associated persons, such as sales practice rules").

[6] Prior to the SEC's adoption of Rule 506(c), which permits the use of general solicitations in Regulation D private placements to accredited investors, each issuer making a private placement needed to have a substantial, pre-existing relationship with each potential investor. See Citizen VC Inc, SEC Staff No-Action Letter (Aug. 3, 2015) (stating that whether such a relationship exists for purposes of Rule 506(b) of Regulation D, which governs "traditional" Regulation D offerings, depends on the facts and circumstances of an offering). A reasonable argument then (that is, prior to the adoption of Rule 506(c)) was that the finder, unlike the issuer, might not have any relationship with the potential investor, and that this lack of a relationship could be detrimental to the accredited investor. Whatever the merits of this position prior to the enactment of Rule 506(c), it no longer is applicable. In a Rule 506(c) offering, an accredited investor can purchase securities from an issuer with whom she has no pre-existing relationship.

[7] In addition, the finder is subject to the anti-fraud provisions of the federal and state securities laws for any material misstatements and omissions in connection with the sale of securities, and these remedies ought to be sufficient to protect the interests of an aggrieved investor who has been wronged by a finder, just as these remedies are available to an aggrieved investor who has been wronged by the issuer.

[8] Cf. David W. Blass, Chief Counsel, SEC Division of Trading and Markets, "A Few Observations in the Private Fund Space," Speech to the American Bar Association, Trading and Markets Subcommittee, Washington, D.C. (Apr. 5, 2013) (stating that the SEC Staff has considered options for more limited regulation of persons who perform only limited broker functions, such as finders).

[9] Interestingly, FINRA recently proposed rules to create a special broker-dealer designation, called a Capital Acquisition Broker, or CAB. See Notice of Filing of a Proposed Rule Change to Adopt the Capital Acquisition Broker Rules, Release No. 34-76675, 80 Fed. Reg. 79969 (Dec. 17, 2015). A CAB is a broker-dealer that would engage in limited activities, including finder's activities. Unfortunately, the only investors to which CABs could offer their services under the proposed rules would be certain financial institutions, and "institutional investors" — essentially people and entities with at least $50 million in assets. Even more unfortunately, despite FINRA's suggestions that CABs would be subject only to those core rules that are critical for finders and similar activities ("CABs would be subject to the FINRA By-Laws, as well as core FINRA rules that FINRA believes should apply to all firms"; id. at 79970), in fact the proposed rules essentially apply all FINRA requirements to CABs and their registered representatives, with the exception of those rules that by their terms regulate solely activities in which a CAB cannot engage.

[10] See, e.g., In the matter of Ranieri Partners LLC and Donald W. Phillips, Securities Exchange Act Release No. 69091 (Mar. 8, 2013) (order initiating and settling cease-and-desist proceedings against an

allegedly unregistered broker-dealer that received transaction-based compensation). The SEC alleged no harm to investors in this order.

[11] It would also be helpful if the SEC could encourage the states to grant comparable relief.

[12] Jumpstart Our Business Startups Act, Section 201(a)(1) (providing for a lifting of the ban on general solicitation in Regulation D offerings in offerings where all securities are sold to accredited investors); Section 201(c) (providing that the sponsors of certain platforms for securities offerings that receive no compensation in connection with the purchase and sale of a security are not subject to registration as a broker-dealer), codified at Section 4 of the Securities Act.

[13] See Securities Act Rule 506(c); AngelList LLC, SEC Staff No-Action Letter (Mar. 28, 2012) (providing no-action relief from broker-dealer registration to an adviser to private funds investing in a single company that would find investors for the fund but receive only performance-based compensation); FundersClub Inc. (SEC Staff No-Action Letter (Mar. 26, 2013) (same). The SEC, again pursuant to provisions Congress added as part of the Jobs Act, has recently authorized nonaccredited investors to help finance private companies, through the adoption of Regulation Crowdfunding and the adoption of Regulation A+.

[14] See Section 760001 of the Fixing America's Surface Transportation Act, codified at Sections 4(a)(7), 4(d) and 18(b)(4)(G) of the Securities Act of 1933.

[15] Investment Advisers Act of 1940, Rule 206(4)-1(a)(1).

[16] Cf. SEC Division of Investment Management, "Guidance on the Testimonial Rule and Social Media," IM Guidance Update No. 2014-04 (Mar. 2014) (permitting a third-party to operate a discussion platform relating to investment advisers that were unaffiliated with that third party, but not allowing an adviser itself to operate such a discussion platform).

[17] It is also noteworthy that the testimonial rule, and the prohibition on a registered adviser receiving a carried interest from a client unless the client has a net worth of at least $2 million, create a strong incentive for investment advisers who operate crowdfunding, peer-lending and similar platforms to register only as exempt reporting advisers, or ERAs. ERAs generally are not subject to the substantive provisions of the Investment Advisers Act that apply to fully registered advisers. The SEC could, by modifying its interpretation of the testimonial rule (and, perhaps, permitting platform advisers to receive a carried interest from accredited investors) in effect encourage appropriate ERAs to "graduate" to fully registered adviser status.

[18] Among other things, the sponsor may need to create a new fund before the first fund is fully or evenly largely invested (if, for example, the sponsor wants investors to always be able to invest in a fund, and therefore needs to always have a fund open and ready to take investments). This can cause the sponsor to need to create a lot of funds, and there can be regulatory concerns that some of those funds should be "integrated" – or treated as a single fund – for purposes of determining whether each fund has no more than 100 investors, or whether each fund has only qualified purchasers as investors.

[19] Such a fund should not have an issue under Regulation M. See Rule 102(b)(3) of Regulation M (permitting redemptions by limited partnerships, at a price based on net asset value, if the redemptions are effected in accordance with the terms of the fund's governing instruments, and if there is no secondary trading market for the fund's interests).

[20] Rule 100(b) of Regulation M, which defines a "distribution" to include an unregistered securities offering "that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods." It is unclear when a particular private placement will be deemed to be of a sufficient magnitude, and to involve such special selling efforts and methods, to be treated as a distribution. However, because many platforms propose to offer private fund investments through the Internet, and perhaps through the use of general solicitation activities, there is at least a reasonable risk that some of these offerings could be treated as involving special selling efforts and special selling methods, and therefore as distributions. See Staff of the SEC Division of Market Regulation (now Trading and Markets), Frequently Asked Questions about Regulation M, Staff Legal Bulletin No. 9 (last revised Sept. 10, 2010) (stating that a private offering "may be a 'distribution' if the offering satisfies the 'magnitude' and 'special selling efforts and selling methods' criteria of the definition of distribution").

[21] Rule 102(b)(3) of Regulation M.

[22] Id.

[23] Anti-manipulation Rules Concerning Securities Offerings, 62 Fed. Reg. 520, 520 (Jan. 3, 1997).

[24] Although it is difficult to envision how a fund sponsor could use this type of system for manipulative purposes, it is worth noting that the other anti-fraud and anti-manipulation provisions of the federal securities laws would still be fully applicable to any such illegal conduct.

[25] See Section 203(l) of and Rule 203(l)-1 of the Advisers Act (permitting advisers to venture capital funds to qualify as exempt reporting advisers).

[26] Section 3(c)(7)(E) of the Investment Company Act (prohibiting the SEC from treating an 100-person fund and a qualified purchaser fund as one fund for purposes of determining compliance with either exemption).

[27] The reason for this is that the accredited investors who invest in a 100-person fund typically invest less than qualified purchasers invest in the qualified purchaser fund.

[28] Under Investment Company Act Section 3(c)(1)(A) and Rule 2a-51-2, the master fund must "look through" both the 100-person fund and the qualified-purchaser fund, and treat each of the investors in those funds as if they had invested directly in the master fund. As a result (assuming there are at least 101 investors in the two feeder funds), the master fund will be deemed to have more than 100 investors, not all of whom are qualified purchasers (i.e., the investors in the 100-person fund).

[29] Section 3(a)(1)(C) of the Investment Company Act.

[30] Rule 3a-8 under the Investment Company Act permits certain research and development companies to invest in a broader range of cash management instruments. The SEC also has issued several "cash management" exemptive orders, which permit those companies to make similar cash management investments. See, e.g., Rio Tinto plc and Rio Tinto Limited, Investment Company Act Release No. 29921 (Jan. 17, 2012) (order) and Investment Company Act Release No. 29889 (Dec. 19, 2011) (notice of application); [cite to Dolby Laboratories]. Unfortunately, those orders are rarely issued, and in any event take many years to obtain.

[31] See SEC v. National Presto, 486 F.3d 305, 309-11 (7th Cir. 2007) (holding that municipal securities backed by US government securities are investment securities).

[32] See Investment Trusts and Investment Companies: Hearings Before House Subcomm. of the Comm. on Interstate and Foreign Commerce on H.R. 10065, 76th Cong., 3d Sess. 176-77 (1940) (statement of David Schenker, Chief Counsel, Investment Trust Study, SEC).