

April 2013

*Practice Groups:**Investment  
Management**Hedge Funds**Alternative  
Investments**Broker Dealer*

## The SEC Staff Permits Sponsors of Securities Trading Platforms to Receive Incentive Compensation

*By Robert H. Rosenblum\**

One of the goals of the JOBS Act was to encourage the development and use of platforms that permit accredited investors to invest in early stage and other private companies. The JOBS Act contains a provision that expressly exempts these platforms from broker-dealer registration if they meet several conditions.<sup>i</sup> One of those conditions is that neither the platform, nor the people associated with the platform (such as employees), may receive “compensation in connection with the purchase or sale” of a security traded on the platform.<sup>ii</sup>

At one end of the spectrum, this compensation restriction prohibits these platforms and their employees from receiving commissions and similar fees related to the sale of securities. At the other end of the spectrum, it is fairly clear that this provision permits a platform to, for example, charge each user a fee to access the platform, regardless of whether the user purchases or sells any securities through the platform. This type of user fee, however, likely would be commercially unacceptable, and generally would ensure that few if any, potential investors would use the platform. As a result, a critical question is whether there is a permissible fee structure that falls between these two ends of the spectrum.

Last week, in two separate “no-action letters” issued to AngelList<sup>iii</sup> and FundersClub,<sup>iv</sup> the Staff of the Securities and Exchange Commission (“SEC”) said that, in fact, there is. Although the two letters are slightly different, they permit platforms to use a “venture fund” model to facilitate investments, and they permit a registered investment adviser affiliated with the platform to receive incentive compensation (that is, compensation that is paid only if the value of the investment increases), and to be reimbursed for documented expenses.<sup>v</sup>

In general, the letters permit the platform to collect non-binding expressions of interest from accredited investors who are interested in investing in a particular early stage company. If the platform receives a sufficient amount of investor interest with respect to a particular company, an adviser affiliated with the platform may then create a limited liability company or other “transaction vehicle” that will accept money from the participating investors. The transaction vehicle then invests all or substantially all of the money in the specified company. Upon the sale or other disposition of the investment, the adviser may receive incentive compensation if the value of the investment has increased. The transaction vehicle also may pay for organizational and other documented third-party expenses. Notably, neither the platform nor the adviser may handle customer money or securities; instead, all money and securities must be held by a bank or other financial institution.

In addition to providing an approach that platform sponsors can use to receive meaningful compensation, these letters also may suggest that the SEC Staff could be willing to consider other compensation arrangements, provided that the compensation reasonably is unrelated to any purchase

<sup>i</sup>Mr. Rosenblum and K&L Gates LLP represented AngelList in connection with the “AngelList no-action letter” discussed in this Alert.

## THE SEC STAFF PERMITS SPONSORS OF SECURITIES TRADING PLATFORMS TO RECEIVE INCENTIVE COMPENSATION

or sale of a security through the platform. For example, in the AngelList and FundersClub no-action letters, the SEC Staff seemed to accept the argument that incentive compensation is tied to the investment performance of a particular security, and not to the purchase or sale of that security.<sup>vi</sup> Significantly, the SEC Staff did not address whether there are circumstances under which a fee based on assets under management would be permissible.

A number of entities other than trading platforms likely also will be able to take advantage of these letters, at least by analogy. For example, private fund managers often would like to pay third parties that are able to introduce investors or deals. Under the SEC Staff's historic position, however, in many cases the third party would or might be required to be a registered representative of a broker-dealer in order for the private fund manager to pay that compensation. The AngelList and FundersClub no-action letters suggest that a private fund manager might now be able to compensate these third-party finders by offering them a portion of the incentive compensation received by the manager.<sup>vii</sup>

Trading platforms or other entities that rely on the AngelList and FundersClub no-action letters need to consider a number of regulatory issues, including the letters' conditions that they register with the SEC or one or more states as investment advisers, and that they make appropriate arrangements with a bank or other financial institution to hold all customer funds and securities. Nonetheless, the letters represent a significant opportunity for trading platforms and other entities to facilitate capital formation without the need for broker-dealer registration.

---

<sup>i</sup> Section 201(c) of the JOBS Act, codified as Section 4(b) of the Securities Act of 1933, as amended (the "1933 Act").

<sup>ii</sup> Section 4(b)(2)(A) of the 1933 Act.

<sup>iii</sup> [AngelList LLC and AngelList Advisors LLC \(SEC No-Action Letter\)](#), March 28, 2013.

<sup>iv</sup> [FundersClub Inc. and FundersClub Management LLC \(SEC No-Action Letter\)](#), March 26, 2013.

<sup>v</sup> The no-action letters technically do not interpret Section 201(c) of the JOBS Act, but instead appear to take the position that the sponsors of the trading platforms described in those letters are best viewed and regulated as investment advisers rather than as broker-dealers.

<sup>vi</sup> By contrast, the SEC and its Staff historically have taken the position that a person who receives compensation payable solely upon the consummation of a particular securities transaction – so-called transaction-based compensation – generally must be registered as a broker-dealer. For example, the SEC recently took enforcement action against a person who it alleged, among other things, acted as a finder for a private equity fund manager and received transaction-based compensation without being registered as or associated with a broker-dealer. See [SEC Charges Private Equity Firm, Former Executive, and Consultant for Improperly Soliciting Investments](#), SEC Litigation Release 2013-36 (March 11, 2013).

<sup>vii</sup> The third-party finders still would have to consider whether their activities required them to register with the SEC or in one or more states as an investment adviser, or in one or more states as an investment adviser representative.

---

### Author:

**Robert H. Rosenblum**

robert.rosenblum@klgates.com

+1.202.778.9464

## THE SEC STAFF PERMITS SPONSORS OF SECURITIES TRADING PLATFORMS TO RECEIVE INCENTIVE COMPENSATION

---

# K&L GATES

Anchorage Austin Beijing Berlin Boston Brisbane Brussels Charleston Charlotte Chicago Dallas Doha Dubai Fort Worth Frankfurt  
Harrisburg Hong Kong Houston London Los Angeles Melbourne Miami Milan Moscow Newark New York Orange County Palo Alto Paris  
Perth Pittsburgh Portland Raleigh Research Triangle Park San Diego San Francisco São Paulo Seattle Seoul Shanghai Singapore Spokane  
Sydney Taipei Tokyo Warsaw Washington, D.C. Wilmington

K&L Gates practices out of 48 fully integrated offices located in the United States, Asia, Australia, Europe, the Middle East and South America and represents leading global corporations, growth and middle-market companies, capital markets participants and entrepreneurs in every major industry group as well as public sector entities, educational institutions, philanthropic organizations and individuals. For more information about K&L Gates or its locations, practices and registrations, visit [www.klgates.com](http://www.klgates.com).

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

©2013 K&L Gates LLP. All Rights Reserved.