FinLaw - Do Funding Platforms under Title II of the JOBS Act have to be broker-dealers?

By Scott Andersen

Section 15(a)(1) of the Securities Exchange Act of 1934 makes it unlawful for businesses to effect transactions in, or to induce the sale of any security, unless registered as a broker-dealer. Many people assume that funding platforms under Title II of the Jumpstart Our Business Startups (JOBS) Act must also register as a broker-dealer or become a branch office of one. They are wrong. And making an expensive and unnecessary mistake in that assumption.

In the crowdfunding space this comes up a lot, either because lawyers have been misinformed or because of pressure from people with a vested interest in the broker-dealer model. So, does a funding platform operating pursuant to Title II need to register as a broker-dealer, or become a branch office of a broker-dealer? No, they certainly can, but they do not have to do so. In the JOBS Act, Congress directed the Securities and Exchange Commission (SEC) to amend its rules to allow general solicitation and advertising for securities offerings being sold to accredited investors. This Act states that a platform "offering or selling" securities under Rule 506, and permitting general solicitation and advertising by the issuers of such securities on its platform, do not need to register as a broker-dealer.[1] Congress was very specific when it created this exemption, explaining that there is no requirement so long as three criteria are met:

1) that the platform does not receive compensation in connection with the purchase or sale of any security;

2) that it does not hold customer funds or securities in connection with the purchase or sale of such security; and,

3) that it is not subject to statutory disqualification.[2]

The bottom line is that a funding platform that meets these requirements does not need to register as (or become a branch office of) a broker-dealer. The issue comes down to regulation, which I'll now discuss...

Broker-dealers fall under a rules-based regulatory system, overseen by FINRA. This can be intense and expensive for a startup business entering the arena. Whether it is applying to become a broker-dealer, conducting due diligence, reviewing marketing materials, complying with supervision rules, or meeting net capital requirements, FINRA rules apply. Examiners review, analyze and question financials, advertising, offering documents, supervision and other areas. Entrepreneurs typically move quickly and need to concentrate their attention on building their business, not on meeting the requirements of a highly regulated industry. As such, you should only become a registered broker-dealer if it is absolutely necessary.

It is true that section 15(a) of the Securities Exchange Act of 1934 requires registration where businesses induce or attempt to induce the purchase or sale of any security. Certain factors (often unclear in application) have been developed for the industry to identify when a company is required to register as a broker/dealer, such as when they receive transaction related compensation, solicit securities transactions, execute trades, or handle customer securities or funds.[3] But the JOBS Act altered the landscape when it specifically permitted securities

solicitation and advertisement, and exempted platforms from registering as broker-dealers so long as they met the three criteria discussed above.

Numerous observers have looked closely at and commented on the SEC 2013 no action letters for FundersClub, Inc. and AngelList LLC,[4] where the SEC Division of Trading & Markets staff agreed not to recommend enforcement actions. While no action letters are notoriously limited as they apply only to the precise facts in the letter, these no action letters nevertheless established precedent where platforms were affirmatively told they did not need to register as broker-dealers. Much of the criteria relied upon by the SEC in this no-action letter was predictable, as it parroted the JOBS Act: the platforms sold Rule 506 offerings to accredited investors, did not earn transaction based compensation (but rather, "carried interest" as they were operating as investment-advisers), did not handle customer securities or funds and were not subject to statutory disqualification.

Now, that said, regardless of whether you operate as a broker-dealer platform or not, participants remain subject to the anti-fraud provisions of the federal securities laws. Participants involved in securities offerings should follow common sense best practices and take reasonable steps to ensure that the offering disclosures comply with the Securities Act of 1933, to verify that money-launderers or persons on regulatory watch lists are not conducting or investing in offerings, that investor's accreditation is being confirmed before securities are sold, and that you are not (unless registered) providing investors with advice or specific securities recommendations (as opposed to "general solicitation").

The crowdfunding industry has already developed solutions to help platforms avoid broker-dealer registration, with at least one technology service provider, FundAmerica, offering escrow, AML and other services so funding platforms can use a third party to handle their customers' funds and meet other regulatory requirements, and thus avoid having to register as a broker-dealer. This solution, and other technology based solutions offered by other firms create opportunities for efficiency and predictability while maintaining compliance and avoiding regulatory headaches (in full disclosure, I am the general counsel for FundAmerica).

So if you are a funding platform that is receiving commissions on securities transactions, or compensation pegged specifically to the success or size of the offering, or holding customer funds or securities, then you do need to be a broker-dealer. But you can avoid becoming a broker-dealer (and the regulatory regime that comes with it) by having a securities attorney help to carefully structure your business so that it falls within the exemption created by the JOBS Act. When this is possible, you will save both money and countless hours of allocating resources and time to regulatory requirements, and thus be able to focus all of your efforts on building your platform into a successful business. The key question thus is not whether a funding platform needs to be a broker-dealer (it doesn't), but rather, how do you structure a funding platform business so that it does not have to be one.

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[1] See JUMPSTART OUR BUSINESS STARTUPS ACT, 112 P.L. 106, 126 Stat. 306, Title II, Section 201(C)(2)(“no person who meets the conditions set forth in paragraph (2) shall be subject to registration as a broker or dealer pursuant to section 15(a)(1) of this title, solely because— ‘(A) that person maintains a platform or mechanism that permits the offer, sale, purchase, or negotiation of or with respect to securities, or permits general solicitations, general advertisements, or similar or related activities by issuers of such securities, whether online, in person, or through any other means;”), at gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf

[2] Id. (The complete language used is “(A) such person and each person associated with that person receives no compensation in connection with the purchase or sale of such security; (B) such person and each person associated with that person does not have possession of customer funds or securities in connection with the purchase or sale of such security; and (C) such person is not subject to a statutory disqualification as defined in section 3(a)(39) of this title and does not have any person associated with that person subject to such a statutory disqualification.”)

[3] See U.S. Securities and Exchange Commission Guide to Broker-Dealer Registration (2008), Section IIA (A "yes" answer to any one of the factors listed indicates that you may need to register as a broker)(emphasis added), at sec.gov/divisions/marketreg/bdguide.htm

[4] See FundersClub, Inc., SEC No-Action Letter (March 26, 2013), 2013 SEC No-Act. LEXIS 271; AngelList LLC and AngelList Advisors LLC, SEC No-Action Letter (March 28, 2013), 2013 SEC No-Act. LEXIS 294.