MORRISON | FOERSTER

Practice Pointers on Matchmaking Basics: How it Works, Current Regulations and Key Considerations

Background

"Matchmaking sites," also referred to as "matchmaking platforms," have come to play a more significant role in capital formation in recent years. A matchmaking site generally relies on the Internet in order to "match" or introduce potential investors to companies that may be interested in raising capital. However, in order to avoid the requirement to register with the Securities and Exchange Commission (SEC) as a broker-dealer, a matchmaking site generally will limit the scope of its activities. Under Section 3(a)(4) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), a "broker" is defined as any person that is "engaged in the business of effecting transactions in securities for the account of others." The SEC has noted that a person "effects transactions in securities if he or she participates in such transactions 'at key points in the chain of distribution'" and that a person is "engaged in the business" if he or she receives transaction-related compensation and holds himself or herself out "as a broker, as executing trades, or as assisting others in completing securities transactions."[1] The determination as to whether an entity is acting as a "broker" is complex. The SEC closely considers many criteria and the specific facts and circumstances. Generally, though, the SEC has attributed great significance to whether the entity receives transaction-based compensation.

Prior to the enactment of the Jumpstart Our Business Startups Act (the "JOBS Act"), the SEC staff issued several no-action letters to matchmaking sites that sought relief from the requirement to register as broker-dealers.[2] The no-action relief generally was conditioned on the requirement that the matchmaking site:

- not provide any advice, endorsement, analysis or recommendation about the merits of securities;
- not receive compensation that is contingent on the outcome or completion of any securities transaction ("transaction-based compensation");
- not participate in any negotiations related to securities transactions;
- not have any role in effecting securities trades;
- not receive, transfer or hold any investor funds or securities; and
- not hold itself out as a broker-dealer.

Section 201 of the JOBS Act

Section 201 of the JOBS Act ("Section 201") provides further legal certainty regarding the activities a matchmaking site may engage in without triggering registration as a broker-dealer. Under Section 201(c), in the absence of other activities that would require registration, a matchmaking site is exempt from the requirement to register as a broker-dealer if in connection with offerings made pursuant to Rule 506 ("Rule 506") of Regulation D under the Securities Act:

- it does not receive compensation based on the purchase or sale of securities;
- it does not handle customer funds or securities; and
- it is not a "bad actor."

In addition, a matchmaking site may maintain a platform or mechanism that permits the offer, sale or purchase of 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.[3].

A matchmaking site also may provide "ancillary services" in connection with Rule 506 offerings Such services include:

- due diligence services, in connection with the offer, sale or purchase of such security (so long as such services do not include, for separate compensation, investment advice or recommendations to issuers or investors); and
- the provision of standardized documents to the issuers and investors (so long as such person or entity does not negotiate the terms of the issuance for, and on behalf of, third parties and issuers are not required to use the standardized documents as a condition of using the service).[4]

---

[1] *See* SEC Denial of No-Action Request to Oil-N-Gas, Inc. (June 8, 2000); SEC Denial of No-Action Request to Progressive Technology Inc. (Oct. 11, 2000); and SEC Denial of No-Action Request to 1st Global, Inc. (May 7, 2001).

[2] *See* Angel Capital Electronic Network, SEC No-Action Letter (Oct. 25 1996); E-Media, LLC, SEC No-Action Letter (Dec. 14, 2000); Swiss American Securities, Inc. and Streetline, Inc., SEC No-Action Letter (May 28, 2002); The Investment Archive, LLC, SEC No-Action Letter (May 14, 2010); Roadshow Broadcast, LLC, SEC No-Action Letter (May 6, 2011); and S3 Matching Technologies LP, SEC No-Action Letter (July 19, 2012).

[3] JOBS Act § 201(c)(2)

[4] *Id*.

Although many articles in the popular press refer to the use of the Internet to offer securities in Rule 506 offerings to accredited investors as "crowdfunding" or "accredited investor crowdfunding," it is important to note that the transactions taking place through such sites do not rely on the exemption under Section 4(a)(6) of the Securities Act for crowdfunded offerings and that the exemption from broker-dealer registration would not necessarily be available for crowdfunded offerings. Crowdfunded offerings must be conducted by either a registered broker-dealer or a registered funding portal.[5]

To date, most matchmaking sites conduct their activities by relying on Rule 506(b) (rather than Rule 506(c)) and the SEC no-action letter *Lamp Technologies.*[6] Under Rule 506(b), an issuer cannot use general solicitation or advertising to market its securities, but may sell its securities to an unlimited number of "accredited investors" and up to 35 other purchasers (so long as such non-accredited investors are sophisticated in financial and business matters).[7] In *Lamp Technologies*, the SEC staff found that the qualification of accredited investors and the posting of a notice concerning a private fund on a website administered by Lamp Technologies, Inc. ("Lamp") that is password-protected and accessible only to subscribers who are predetermined to be accredited investors would not involve a general solicitation or advertising.[8] In order to obtain access to private fund information available on the website, potential subscribers would be required to (1) complete a questionnaire designed to allow Lamp to form a reasonable basis for determining that the subscriber was an accredited investor and (2) pay a subscription fee. Subscribers who pre-qualified as accredited investors and paid the subscription fee would receive a password permitting them access to the website and Lamp would require subscribers to agree not to invest in any posted fund for 30 days following their qualification. The SEC staff noted that (1) both the invitation to complete the questionnaire used to determine whether an investor is accredited and the questionnaire itself would be generic in nature and would not reference any specific funds posted or to be posted on the password-protected website, (2) the password-protected website would be available to a particular investor only after Lamp made the determination that the particular potential investor was accredited, and (3) a potential investor could purchase securities only after the 30-day waiting period.[9]

Therefore, contacting solely accredited investors or making opportunities available only after an investor has been identified as accredited would not necessarily constitute general solicitation or advertising and force a matchmaking site to consider relying on Rule 506(c). Rule 506(c), in contrast to Rule 506(b), permits general solicitation if all of the investors are accredited investors and the issuer takes reasonable steps to verify that the investors are accredited investors.

SEC Frequently Asked Questions

In order to provide additional guidance relating to matchmaking sites, the SEC staff issued a set of Frequently Asked Questions ("FAQs") on February 5, 2013.[10] The key FAQs are summarized below:

- Question 2 asked whether the exemption from registration under Section 4(b) of the Securities Act ("Section 4(b)") is operational in light of the fact that broker-dealers are required to register under the Exchange Act. The SEC staff responded that the exemption is fully operational because Congress exempted persons described in Section 4(b) from broker-dealer registration requirements under Section 15(a)(1) of the Exchange Act.
- Question 3 asked if the Section 4(b) exemption is available to an online platform that offers and sells securities not sold pursuant to Rule 506. The SEC staff responded that the exemption only applies when securities are offered and sold pursuant to Rule 506.
- Question 4 asked whether an Internet website or social media would qualify as a permissible "platform or mechanism" for general solicitation purposes. The SEC staff responded that Congress specifically intended Section 4(b)(1)(A) to cover social media and Internet websites.
- Question 5 asked what forms of compensation would cause an entity to be unable to rely on the Section 4(b) exemption. In

---

[5] For more information regarding the SEC's final crowdfunding rules, *see* our client alert, "Following the Wisdom of the Crowd?: A Closer Look at the SEC's Final Crowdfunding Rules" (Nov. 2, 2015), *available at:* https://media2.mofo.com/documents/151102seccrowdfunding.pdf.

[6] *See* Lamp Technologies, Inc., SEC No-Action Letter (May 29, 1997) (hereinafter, "Lamp Technologies").

[7] Under Rule 506(c), a company can broadly solicit and generally advertise the offering, but the investors in the offering must all be accredited investors and the company must take reasonable steps to verify that its investors are accredited investors. For more information regarding the use of general solicitation, *see* Ze'-ev Eiger, David Lynn, Jared Kaplan and Anna Pinedo, "Practice Pointers on Navigating the Securities Act's Prohibition on General Solicitation and General Advertising," The Investment Lawyer, Vol. 23, No. 9 (Sept. 2016), *available at*: https://media2.mofo.com/documents/160900-practice-pointers-general-solicitation.pdf.

[8] *See also* IPOnet, SEC No-Action Letter (July 26, 1996) (stating that a general solicitation is not present when there is a pre-existing, substantive relationship between an issuer, or its broker-dealer, and the offerees, and that the posting of a notice of a private offering on a website would not be deemed a general solicitation or advertising when pre-qualification and password-protection procedures designed to limit access to the website were in place).

[9] The SEC staff, however, did not take a position as to whether the information obtained by Lamp was sufficient to form a reasonable basis for believing an investor to be accredited. The SEC staff also has indicated that in order to establish a pre-existing substantive relationship, a registered person or other intermediary must not only obtain information about a prospective investor's financial sophistication and status, but it also must have the means to, and must, verify this information. *See* Citizen VC, Inc., SEC No-Action Letter (Aug. 6, 2015).

[10] *See* Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act, *available at* http://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm.

its response, the SEC staff indicated that impermissible compensation is not limited to transaction-based compensation. However, co-investment in the securities offered on an online platform is permissible compensation for the purposes of Section 4(b).

- Question 6 asked if an entity such as a venture capital fund can operate an Internet website that lists offerings of securities by potential portfolio companies. In its response, the SEC staff indicated that subject to the restriction on transaction-based compensation under Section 201, an entity such as a venture capital fund or its adviser may operate an Internet website that lists offerings of securities, and such websites may also provide standardized documents for use by issuers and investors.
- Question 7 asked whether an associated person of an issuer of Rule 506 securities could rely on the Section 4(b) exemption to maintain a "platform or mechanism" for the issuer's securities. The SEC staff responded that such reliance is permitted, assuming the associated person otherwise qualifies for the exemption.
- Question 8 asked whether an entity whose staff is paid a salary to promote, offer, and sell shares of privately offered funds are exempt from registration under Section 4(b). In its response, the SEC staff indicated that the exemption is not available to any person who is paid a salary to promote, offer, or sell shares of a privately offered fund.
- Question 9 asked if an entity who is exempt from registration as a broker-dealer is nonetheless a broker-dealer. The SEC staff indicated that even those who are exempt from registration are still considered broker-dealers.
- Question 10 asked whether Section 4(b) provides an exemption from state registration requirements, to which the SEC staff responded that the exemption only applies to federal registration requirements.

SEC No-Action Relief

In March 2013, the SEC staff granted the first no-action relief from registration as a broker-dealer subsequent to the JOBS Act taking effect.[11] In *FundersClub Inc. and FundersClub Management LLC*, the SEC staff indicated that it would not recommend enforcement action under Section 15(a)(1) of the Exchange Act if FundersClub Inc. ("FundersClub") and FundersClub Management LLC ("FC Management") operated a platform through which its members could participate in Rule 506 offerings. FundersClub identified start-up companies in which its affiliated fund would invest and then posted information about the start-up companies on its website so that the information was only available to FundersClub members, who were all accredited investors. The FundersClub members could submit non-binding indications of interest in an investment fund, which relied on Rule 506 to conduct an offering. When a target level of capital was reached, the indication of interest process was closed, and FundersClub reconfirmed investors' interest and accredited investor status and negotiated the final terms of the investment fund's investment in the start-up company. Members could withdraw their indications of interest at any time. FundersClub and FC Management did not receive any compensation in connection with the purchase or sale of securities, but an administrative fee was charged. FundersClub and FC Management also intended to be compensated for their role in organizing and managing the investment funds (at a rate of 20% or less of the profits of the investment fund but never exceeding 30%). Although the no-action relief was granted pursuant to Section 15(b) of the Exchange Act, the SEC staff noted that FundersClub's and FC Management's activities appeared to comply with Section 201 because FundersClub, FC Management and each person associated with them received no compensation (or the promise of future compensation) in connection with the purchase or sale of securities.

In *AngelList LLC*, the SEC staff granted no-action relief to AngelList LLC ("AngelList") from the requirement to register as a broker-dealer in connection with the establishment of an Internet-based platform to facilitate angel investing by accredited investors.[12] The SEC staff noted that AngelList's Internet-based platform had to be "exclusively available" to accredited investors. In order to remain exempt from broker-dealer registration, the SEC staff also indicated that AngelList could not receive any transaction-based compensation.[13] In addition, the SEC staff stated that AngelList could not solicit investors outside of the website itself, and the specific terms of any compensation paid to AngelList-affiliated investment advisers must be described in any offering document. The distinction between the FundersClub and AngelList platforms lies in the latter's proposed use of a "lead angel," who would identify the start-up and structure terms of the investment. In its request letter, AngelList stated that the lead angel would not receive a management fee. Instead, compensation would be restricted to a back-end carried interest that would be shared between an AngelList-affiliated investment adviser and the lead angel. However, the SEC staff may have opened the door for other unique fee arrangements by not treating back-end carried interest as transaction-based compensation. Moreover, the SEC staff conditioned its no-action relief on the fact that AngelList's services did not extend beyond traditional advisory and consulting services.

Although helpful in certain respects, *FundersClub* and *AngelList* are narrowly focused and do not address whether other registrations, such as registration as an investment adviser under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), are required for the activities described therein.

---

[11] *See* FundersClub Inc. and FundersClub Management LLC, SEC No-Action Letter (Mar. 26, 2013) (hereinafter, "FundersClub").

[12] *See* AngelList LLC, SEC No-Action Letter (Mar. 28, 2013) (hereinafter, "AngelList").

[13] The SEC staff did not address whether Section 201 was applicable.

So long as the matchmaking website adheres to the aforementioned requirements and does not receive transaction-based compensation, it will be exempt from registration as a broker-dealer. However, *FundersClub* and *AngelList* do not definitively explain whether registration as a broker-dealer is required for matchmaking sites that have different functions and compensation structures.

Key Considerations

For Issuers

Given the popularity of matchmaking sites, an issuer may consider using such a service in connection with a proposed Rule 506 offering. However, there are a few considerations that should be taken into account when choosing a matchmaking site over a traditional broker-dealer or financial adviser. First, there may be a benefit to using a traditional broker-dealer or financial adviser because a broker-dealer or financial adviser has a suitability obligation with respect to investors. In order to meet its suitability obligation, a traditional broker-dealer or financial adviser may be more focused on ascertaining whether an investor is experienced in investing in private offerings and may identify investors who have fewer liquidity needs. Second, if an issuer chooses to use a matchmaking site, the issuer should be prepared to have a more dispersed ownership (assuming accredited investors invest individually and not through a fund) and consider how this might affect the issuer's capital structure and the issuer's activities in the future. For example, if special rights are assigned to various classes of securities (*e.g.*, voting rights, rights of first refusal, etc.), a more dispersed ownership will make it more difficult to effect or obtain waivers of such rights. A more dispersed ownership may also make it more difficult for the issuer going forward (after the financing) to contact holders in order to verify for Exchange Act Section 12(g) purposes (if the issuer is still a private company) that the holders are still accredited investors.[14] Third, there might also be a benefit to having a financial adviser help "position" the issuer with respect to marketing for the financing, which may include taking the issuer on a "road show" to meet with potential investors. These types of marketing efforts are not possible with matchmaking sites. Fourth, consideration should be given to how the issuer's existing holders may view the financing, including the potential investor base. Again, existing holders may have certain rights that may be implicated in a contemplated financing.

In addition, while some may view matchmaking sites as helping to democratize venture capital, some issuers may find using traditional broker-dealers or financial advisers preferable in the sense that they offer issuers an experienced investor base that can add value to the enterprise. For example, traditional broker-dealers or financial advisers may introduce issuers to entrepreneurs, engineers, recruiters, marketers, testers and the most experienced investors, who can provide value to issuers.

If an issuer decides to use a matchmaking site, then the issuer and its counsel should familiarize themselves with the business model and the operations of the matchmaking site. The issuer needs to know (1) whether the matchmaking site is relying on the exemption under Section 201, or whether the matchmaking site is a registered broker-dealer or intends to be exempt from registration, and (2) the functions or services that the matchmaking site will provide in connection with the financing. If the matchmaking site is not a registered broker-dealer or is not relying on the exemption under Section 201, then its compensation structure will determine whether the matchmaking site is exempt from registration. Furthermore, the issuer needs to know whether the activities of the matchmaking site are organized in a manner that would constitute a "general solicitation." If the matchmaking site is using general solicitation, then the issuer must rely on Rule 506(c) for its exemption and then will need to take "reasonable efforts" to verify that the investors are accredited.

"Reasonable efforts" to verify investor status should include consideration of the nature of the investor, the nature and amount of information about the investor and the nature of the offering. Rule 506(c)(2)(ii) sets forth non-exclusive and non-mandatory accredited investor verification methods that, if satisfied, serve as safe harbors for issuers who will be deemed to have satisfied the "reasonable steps" verification requirement. The safe harbor verification methods include obtaining written confirmation from a third party of their verification of accredited investor status within the past three months. The SEC has also provided additional guidance on the investor verification process in the form of Compliance and Disclosure Interpretations.[15]

For Matchmaking Sites

As emphasized in a July 2014speech by David W. Blass, Chief Counsel of the SEC's Division of Trading and Markets, in connection with any collective investment scheme for angel investing or venture capital or private equity investing for startups and emerging companies, fund sponsors and matchmaking sites should carefully consider their activities and determine whether specific exemptions from broker-dealer registration are available.[16] Acting as an unregistered broker-dealer should not be viewed as only a technical violation because engaging in these activities without registration can have serious consequences. For example, in addition to being

---

[14] Under Exchange Act Section 12(g), an issuer must register a class of equity securities if, at the end of its fiscal year, an issuer has at least $10 million in assets and a class of equity securities held of record by either 2,000 persons or 500 persons who are not accredited investors.

[15] *See, e.g.*, "What's New in the Division of Corporation Finance, July 2014," *available at:* http://www.sec.gov/divisions/corpfin/cfnew/cfnew0714.shtml.

[16] *See* speech of David W. Blass, Chief Counsel, Division of Trading and Markets, titled "A Few Observations in the Private Fund Space" (Apr. 5, 2013), *available at:* http://www.sec.gov/News/Speech/Detail/Speech/1365171515178#.VLkzYWl0xWI.

subject to sanctions by the SEC, another possible consequence of acting as an unregistered broker-dealer is the potential right of rescission that an investor may have.[17]

Fund sponsors and matchmaking sites should also consider whether their activities require registration as investment advisers under the Advisers Act. Although using social media to engage in selling activities would not by itself trigger registration as an investment adviser, the SEC has provided guidance on the applicability of Rule 206(4)-1(a)(1) under the Advisers Act to social media use by investment advisers, which applies to all investment advisers, whether or not they are registered under the Advisers Act.[18]

In this regard, *FundersClub* and *AngelList* are helpful, but only to a limited extent. As noted above, *FundersClub* and *AngelList* relied solely on the Rule 506 exemption and did not involve commissions on sales, finder's fees, success fees or management fees, just carried interest. Although committing to receive only carried interest is essentially co-investment, it remains to be seen whether limiting compensation to solely carried interest will be economically viable for matchmaking sites in the long-run. Matchmaking sites also are still relatively new and evolving; thus, it remains to be seen whether matchmaking sites will continue to structure themselves like the platforms used in *FundersClub* and *AngelList* or will adopt different models, register as broker-dealer dealers or structure themselves as funding portals, which can participate in crowdfunded offerings.

Matchmaking sites must also decide whether they will use (1) the Rule 506(c) exemption (which permits general solicitation or advertising) or (2) the Rule 506(b) exemption with protections in place to restrict non-accredited investors from gaining access. If a matchmaking site chooses to use the Rule 506(c) exemption, then it must decide whether the investor verification will be performed by itself or a third-party vendor. There may also be compliance costs associated with investor verification, and privacy and other protections will be needed to safeguard sensitive investor information, which could be significant. Further, if the investor verification will be performed by a third-party vendor, the matchmaking site will need to consider the kind and level of due diligence performed by such vendor and whether it will be adequate.

Contact
Ze'ev Eiger
New York
(212) 468-8222
zeiger@mofo.com

[17] In the same speech, Mr. Blass mentioned that the SEC was working collaboratively with FINRA on a more customized approach for regulation of market participants who perform only limited broker-dealer functions. In this context, Mr. Blass mentioned the SEC staff's work with FINRA to consider the appropriate level of regulation for funding portals given the limited scope of their activities. Mr. Blass also noted that the SEC staff was considering whether there were opportunities to extend the approach to other types of brokers-dealers whose activities are limited.

[18] *See* IM Guidance Update, No. 2014-04 (Mar. 2014), *available at:* http://www.sec.gov/investment/im-guidance-2014-04.pdf. For more information regarding SEC guidance on social media use by investment advisers, *see* our guide, "The Guide to Social Media and the Securities Laws" (July 2015), *available at:* http://media.mofo.com/docs/pdf/150615-Guide-Social-Media-Securities/#?page=0. For more information regarding investment adviser issues that the SEC will focus on, *see* speech of Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, titled "People Handling Other Peoples' Money" (Mar. 6, 2014), *available at:* http://www.sec.gov/News/Speech/Detail/Speech/1370541260300#.VLlArGl0xWJ.