

FENDING FOR THEMSELVES: WHY SECURITIES REGULATIONS SHOULD ENCOURAGE ANGEL GROUPS

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America loves its startup companies in good times and bad. Widespread losses from the dot-com bubble are not far behind us,¹ yet we continue to praise entrepreneurs as engines of economic growth and job creation.² More recent economic turmoil and upheaval only strengthened the sentiment. Thomas Friedman put it succinctly in a 2009 editorial: “Start-ups, not bailouts: nurture the next Google, don’t nurse the old G.M.’s.”³

In many respects, current public policy reflects this enthusiasm for startups. State and local governments make tax credits available to investors in startups, and entrepreneurs have received billions in public funding for new ventures.⁴

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1. See Chad Bray, *Judge Tentatively Approves IPO Settlement*, WALL ST. J., June 11, 2009, <http://online.wsj.com/article/SB124473596936806625.html> (reporting tentative settlement “in long-running shareholder litigation over the allocation of initial public offerings during the Internet boom of the late 1990s”).

2. John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting*, 37 ARIZ. ST. L.J. 861, 864-75 (2005) (“The small businesses that have demonstrated a capacity to create a disproportionate amount of the macroeconomic growth, innovation, and net new jobs in the United States are the rapid-growth start-ups.”); William K. Sjostrom, Jr., *Relaxing the Ban: It’s Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1, 1-2 (2004) (discussing ability of “entrepreneurial companies that start small and grow fast” to create jobs).

3. Thomas L. Friedman, *Start Up the Risk-Takers*, N.Y. TIMES, Feb. 22, 2009, at 10; see also, Thomas L. Friedman, *Invent, Invent, Invent*, N.Y. TIMES, June 28, 2009, at 8 (“Lately, there has been way too much talk about minting dollars and too little about minting our next Thomas Edison, Bob Noyce, Steve Jobs, Bill Gates, Vint Cerf, Jerry Yang, Marc Andreessen, Sergey Brin, Bill Joy and Larry Page.”).

4. Darian M. Ibrahim, *Financing the Next Silicon Valley*, 87 WASH. U. L. REV. 717, 736 (2010) (“[O]ver half of the states have adopted or considered adopting some form of state-sponsored venture capital fund.”); MICHAEL B. STAEBLER, PEPPER HAMILTON LLP, AN OVERVIEW OF THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM (2010), www.nasbic.org/resource/resmgr/Legal_Issues/pepper_hamilton_overview.pdf (discussing

Nonetheless, it remains difficult for entrepreneurs to obtain sufficient funding for new high-growth companies (a process this article refers to as “startup company finance”).⁵ There is an expanding “funding gap” between the amounts of capital entrepreneurs can raise from personal sources such as friends and family (typically below \$500,000) and the minimum amounts venture capital funds invest (now, typically \$5,000,000).⁶

Some of this difficulty is inherent in startups. These companies and their products are unproved. Even a successful investment in a startup company is illiquid and must be held for years.⁷ Most startups fail.⁸

But these challenges are not insurmountable. Specific types of investors have an appetite for, and a demonstrated ability to manage, these risks. Venture capital funds are the best-understood example. Financial economists and legal scholars have observed for decades that professional managers of venture capital funds employ strategies designed to overcome the unique risks of startups.⁹

Only more recently have academics also focused on the investment practices of the wealthy individuals, or “angel investors,” who fund these companies even before they are ready for venture capital.¹⁰ Investment practices that were once thought to indicate a lack of sophistication or bargaining power are now understood as rational responses to the early

federal funding for small businesses); NAT'L GOVERNORS ASS'N CTR. FOR BEST PRACTICES, STATE STRATEGIES TO PROMOTE ANGEL INVESTMENT FOR ECONOMIC GROWTH (2008), available at <http://www.nga.org/Files/pdf/0802ANGELINVESTMENT.PDF> (discussing tax credits for investors).

5. Orcutt, *supra* note 2, at 869 (“At the start-up’s early stages . . . the external funding options are typically very limited.”); Sjostrom, *supra* note 2, at 3 (“Many emerging companies fail to raise critical early-stage capital largely because of market inefficiencies.”); see George W. Dent, Jr., *Venture Capital and the Future of Corporate Finance*, 70 WASH. U. L.Q. 1029, 1032-34 (1992) (describing difficulties startups face obtaining loans and accessing public equities markets).

6. See *Private Equity for Small Firms: The Importance of the Participating Securities Program: Hearing Before the H. Comm. on Small Bus.*, 109th Cong. 37-67 (2005) [hereinafter *Participating Securities Hearings*] (statement of Colin C. Blaydon, Director, Center for Private Equity and Entrepreneurship, and Susan L. Preston, Entrepreneur-in-Residence, Ewing Marion Kauffman Foundation); Ibrahim, *supra* note 4, at 730-31 (noting the capacity of venture capital investors to diversify their portfolio of startup investments); Orcutt, *supra* note 2, at 873 (attributing the growing funding gap to higher venture capital investment amounts caused by increasing fund sizes).

7. See *infra* text accompanying note 80.

8. See *infra* text accompanying note 24.

9. See *infra* text accompanying notes 44, 88-99.

10. Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1406-07 (2008) (“Despite their importance, angels are surprisingly underappreciated in the popular press and academia, especially legal academia.”).

stage at which angels invest.¹¹

Not only is our understanding of startup company finance evolving—so are the practices of investors in this market. Angel investors, for example, increasingly collaborate to meet increasing demand for their capital. Long dependent on a personal “network of trust” to locate investments,¹² angel investors are expanding their reach by organizing into groups ranging from loose affiliations to more formal structures that employ an active manager similar to a venture capital fund.¹³ While these groups currently account for a minority of angel investing¹⁴ (and may not be a complete solution to the funding gap),¹⁵ they are an example of how angel investors are adapting to a growing funding gap.

Unfortunately, securities laws have not kept pace with the evolving market for startup company finance, and in fact are an impediment to efforts by private actors to close the funding gap. The Securities and Exchange Commission’s (“SEC’s”) current regulations constrain a company’s ability to market its stock directly to investors by prohibiting a “general solicitation” of securities.¹⁶ The ban on general solicitation is designed to channel sales efforts through regulated intermediaries, such as

11. See generally Ibrahim, *supra* note 4 (noting that angel investing has advantages over other methods of funding entrepreneurial ventures in non-tech regions); Ibrahim, *supra* note 10 (describing the importance of angel investors in entrepreneurial finance); Brent Goldfarb, Gerard Hoberg, David Kirsch & Alexander Triantis, *Does Angel Participation Matter? An Analysis of Early Venture Financing* (Robert H. Smith Sch. of Bus., Univ. of Md., Working Paper No. RHS-06-072, 2009), available at <http://ssrn.com/abstract=1024186> (analyzing the constraints and merits of angel investor participation in startup funding); Robert Wiltbank, *At the Individual Level: Outlining Angel Investing in the United States* (Univ. of Ill. at Urbana-Champaign’s Acad. for Entrepreneurial Leadership Historical Research Reference in Entrepreneurship, 2005), available at <http://ssrn.com/abstract=1509255> [hereinafter Wiltbank, *At the Individual Level*] (summarizing empirical research of angel investing within the United States); Robert Wiltbank, *Investment Practices and Outcomes of Informal Venture Investors*, 7 VENTURE CAPITAL 343 (2005) [hereinafter Wiltbank, *Investment Practices*] (comparing formal venture capital investment to angel investing).

12. Orcutt, *supra* note 2, at 895 (citing LUCINDA LINDE & ALOK PRASAD, VENTURE SUPPORT SYSTEMS PROJECT: ANGEL INVESTORS 26 (MIT Entrepreneurship Ctr.) (2000)).

13. See *infra* text accompanying notes 55-69.

14. Ibrahim, *supra* note 10, at 1443 (“Traditional angel investments still constitute the bulk of the angels market. They account for somewhere between seventy and ninety percent of all angel investments.”).

15. *Participating Securities Hearings*, *supra* note 6, at 61 (“As yet, no one has created a crystal ball which will assure the future of angel capital as an adequate and effective resource for the funding gap. Nor should any intelligent economy rely on one source to meet these critical economic needs, just as companies would not single source a crucial part of the product.”); see also Ibrahim, *supra* note 4, at 742-43 (describing inability of angel groups to provide complete funding, but noting the valuable signaling role groups can serve for later venture capital investment).

16. See *infra* text accompanying notes 147-165.

broker-dealers or investment advisers.¹⁷ While this approach may be sensible in other contexts, it has historically produced bad results for startups. The regulatory framework for these conventional intermediaries is too cumbersome for early-stage financing,¹⁸ so high-quality intermediaries are not available to startups. Moreover, the framework for regulating intermediaries, based on a snapshot of financial markets in the 1930s, does not adapt well to the emergence of new intermediary forms. This is demonstrated by the need for legislative action to secure favorable status for venture capital funds.

It is not surprising, then, that commentators are questioning the status of angel groups under securities regulations, including whether they violate the ban on general solicitation or require registration as broker-dealers or investment advisers.¹⁹ To date, these discussions are only scratching the surface, noting the potential legal risks but not considering the full range of angel groups currently in operation.²⁰

This article argues that angel groups do not violate the ban on general solicitation or trigger intermediary registration requirements. This argument recognizes that angel groups—even those that resemble venture capital funds by employing an active manager receiving substantial compensation—are, at their core, investor-led efforts. This active-investor model should adequately distinguish angel groups from the types of intermediaries that securities laws were intended to regulate, and ensures that these groups function similarly to other investor-led forums where the SEC has relaxed the ban on general solicitation.

This argument serves two purposes. One is to ensure that the activities of angel groups are not prematurely chilled because a degree of legal uncertainty has been identified. Most of the SEC's guidance in this area comes in the form of ad hoc no-action letters citing long lists of facts and circumstances underlying the SEC's decisions.²¹ The logic of these

17. See *infra* text accompanying notes 161-164.

18. See *infra* text accompanying note 170.

19. See Ibrahim, *supra* note 4, at 753-61 (discussing applicability of the ban on general solicitation and broker-dealer regulations to angel groups); Michael T. Raymond, *New Developments in Raising Private Capital for Early Stage Companies*, INST. OF CONTINUING LEGAL EDUC., 1 (2004), available at http://www.dickinson-wright.com/upload_files/BLI%20Presentation%20Outline.pdf (discussing securities regulations applicable to angel investor financing of startups).

20. See *infra* note 294 (discussing how actively managed angel groups raise issues that are not addressed by Raymond and Ibrahim).

21. SEC no-action letters typically include a paragraph stating that the letter represents a position regarding enforcement only, does not represent a legal conclusion regarding applicability of statutes or regulations, and is based on the specific facts presented. Nonetheless, they are often relied on in the absence of other authority. See Orcutt, *supra* note 2 (discussing the role of no-action letters in formulating securities laws).

letters is hard to discern, making it difficult to analogize to new developments like angel groups. But by looking broadly at the principles underlying a wide variety of private offering regulations, rather than myopically at some unfavorable elements in relevant SEC interpretations, persuasive arguments emerge for why current regulations can accommodate a wide range of angel group forms.

The second reason for analyzing angel groups under current law is to highlight broader problems with existing regulatory frameworks by demonstrating how difficult it is to discern a coherent conceptual framework from existing laws. Concepts such as whether a “general solicitation” of investors has occurred and whether intermediaries receive “transaction-based compensation” are key to whether angel groups comply with securities laws. But these concepts are poorly defined by courts and regulators, making them difficult to apply to new practices and leaving substantial room for reaching a different conclusion than is reached in this article. Besides being indeterminate, as we better understand how angel investors effectively fend for themselves, these ethereal concepts appear increasingly irrelevant to the overarching purpose of protecting investors.

This article concludes with a reform proposal. The reform would relax the ban on general solicitation and intermediary registration requirements in circumstances where angel investors have demonstrated an ability to protect themselves. In doing so, it would provide not only more certainty with respect to current practices, but also more flexibility to allow future innovations that could close the funding gap.

I. MARKET PARTICIPANTS

Traditional participants in startup company finance include startup companies, venture capital funds, and individual angel investors. In recent years, angel groups have also gained popularity. This part includes a brief description of these market participants as context for the discussion that follows.

A. *Startup Companies*

A startup company is a new venture with an innovative product or business model that targets rapid growth. This definition distinguishes startup companies from “livelihood businesses,” which generate income for the company founders and employees, but lack significant prospects for generating large returns to outside investors through an initial public

offering of stock (“IPO”), or by being acquired.²² Successful startup companies include Microsoft, Google, and Starbucks, but the category also includes failures, including many dot-com bubble victims.²³

Statistically, a startup company will probably fail. Even considering only those companies that obtain funding, approximately two-thirds do not generate positive returns to investors.²⁴

B. VC Funds

“Venture capital” means a pool of professionally managed funds provided by passive investors for investment in startup companies. This article uses the term “VC investors” to refer to the investors who provide capital, “VC managers” to refer to the entities and individuals who choose and monitor investments on behalf of the fund, and “VC funds” to refer collectively to the VC investors, the pool of capital, and the VC managers. Legally, a VC fund is typically a limited partnership with the VC investors as the limited partners and an entity formed by the VC managers as the general partner.²⁵

1. Professional Intermediaries

VC managers are financial intermediaries.²⁶ They engage in a “venture capital cycle” of raising capital, deploying it by making investments, distributing returns to investors, and launching new funds.²⁷

VC managers are a unique form of intermediary because they have an intensive and long-term role in monitoring investments. In contrast, many intermediaries have little or no ongoing role after an initial investment is made. Examples are stockbrokers, who help execute or recommend trades of stock listed on a stock exchange,²⁸ and underwriters, who market and sell

22. Orcutt, *supra* note 2, at 862 (distinguishing livelihood businesses from “rapid-growth startups”).

23. See William W. Bratton, *Venture Capital on the Downside: Preferred Stock & Corporate Control*, 100 MICH. L. REV. 891, 891 n.1 (2002) (“In the first seven months of 2001, 367 internet companies went out of business, and nearly 83,000 dot-com employees were laid off.”).

24. See *infra* text accompanying notes 115-121.

25. MICHAEL J. HALLORAN ET AL., *VENTURE CAPITAL & PUBLIC OFFERING NEGOTIATION* 1-7 (3d ed. 1999) (providing template of venture capital limited partnership agreement).

26. Orcutt, *supra* note 2, at 888-90; George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305, 307-19 (2001) (comparing VC managers and banks as financial intermediaries).

27. See *generally* PAUL GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* (2d ed. 2004) (explaining the cycle of venture capital fundraising and investment).

28. See *Cutting Through the Confusion: Where to Turn for Help with Your*

securities to investors in an IPO.²⁹

There are other intermediaries who, like VC managers, have ongoing management responsibilities for a pool of funds or portfolio of investments. Examples are: hedge fund managers, who typically make and manage investments in publicly traded stock, commodities, and related derivatives;³⁰ mutual fund managers, who make and manage investments in publicly traded stocks and bonds;³¹ and traditional investment advisers (or “wealth managers”), who manage an investment account for a specific person or entity.³² These fund or account managers, however, often manage a portfolio of relatively liquid investments with ascertainable market values, so their performance can be evaluated somewhat regularly, and the relationship between the investor and the intermediary can be terminated (by liquidation of the account or redemption by the fund) at regular intervals.³³ VC investors, in contrast, are typically committed to the fund for its duration because the investments are long-term and illiquid.³⁴ The monitoring role of VC managers is also unique because they are actively involved in the operations of the companies in which they invest.³⁵ Hedge fund managers and mutual fund managers do not generally play an active management role in portfolio companies because the investments that they facilitate are typically passive.³⁶

The standard fee arrangement for VC managers reflects its intensive monitoring role and the long-term nature of the investments the managers

*Investments, COAL. ON INVESTOR EDUC., available at <http://www.nasaa.org/content/getsearchablefile.cfm?FamilyID=5583&filename=CuttingThroughTheConfusion.pdf> [hereinafter *Cutting Through the Confusion*] (comparing investment advisers and stockbrokers).*

29. See Orcutt, *supra* note 2, at 885-86 (discussing underwriters as intermediaries).

30. SHARTSIS FRIESE LLP, U.S. REGULATION OF HEDGE FUNDS 1 (2005) (“Hedge Fund” has no uniformly accepted meaning, but commonly refers to a professionally managed pool of assets used to invest and trade in equity securities, fixed-income securities, derivatives, futures and other financial instruments.”).

31. See Orcutt, *supra* note 2, at 887-88 (describing mutual funds as “collectivizing agent[s]” for shareholders).

32. See *Cutting Through the Confusion*, *supra* note 28 (summarizing the roles and duties of common forms of investment advisers).

33. See, e.g., SHARTSIS FRIESE LLP, *supra* note 30, at 3 (stating that hedge fund investors are typically permitted to withdraw on a quarterly basis).

34. See HALLORAN, *supra* note 25, at 1-130 to -133 (including VC partnership agreement limiting rights of withdrawal).

35. See *infra* text accompanying notes 92-94 (describing board and control rights of VC funds).

36. Activist hedge funds are an exception to this rule. They purchase a stake in an underperforming publicly traded company and press management for changes. See generally April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187 (2009) (examining recent trends in shareholder activism).

facilitate. The fee typically has two components: a management fee equal to approximately 2.5% of assets under management,³⁷ and a “carried interest” typically equal to 20% of gains realized by the fund on investments.³⁸ The management fee covers the cost of actively monitoring investments, while the carried interest aligns the long-term incentives of the VC investors and manager.

2. Institutional Capital

VC investors are largely sophisticated, institutional investors. Approximately two-thirds of VC investors are pension funds, endowments, or foundations.³⁹

3. Geography

VC funds are headquartered in a handful of geographic hot spots, most notably Silicon Valley and the Route 128 area near Boston. California VC funds accounted for over \$84 billion of the approximately \$200 billion under management by VC firms in 2008, and Massachusetts VC funds accounted for an additional \$36 billion.⁴⁰

VC funds are not only headquartered in select areas, but also concentrate their investments in companies located in those areas. Nearly half of the total dollar value of 2008 VC investments went to companies located in California. That year, VC funds invested over \$1 billion of VC capital in each of California, Massachusetts, Texas, Washington, and New York, accounting for over two-thirds of all VC investments.⁴¹ Alternatively, six states and territories received from zero to \$1 million in

37. See HALLORAN, *supra* note 25, at 1-51, 1-108 (providing VC partnership agreement with management fees based on net asset value and committed capital); Ibrahim *supra* note 4, at 733 n.63 (“The management fee is typically two percent of the risk capital in the venture fund”); William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 491 (1990) (finding that over 50% of surveyed VC fund agreements include management fee equal to 2.5% of committed capital).

38. HALLORAN, *supra* note 25, at 1-51; see also Sahlman, *supra* note 37, at 491 (finding that 88% of surveyed VC fund agreements provide VC managers with 20% of gains).

39. See Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-ups*, 57 TAX L. REV. 137, 157 n.86 (2003) (citing statistics from the National Venture Capital Association’s 2002 Yearbook); Sahlman, *supra* note 37, at 488 (reporting that in 1988, 64% of venture capital came from pension funds, endowments, and insurance companies).

40. NAT’L VENTURE CAPITAL ASS’N, 2009 VENTURE CAPITAL ASSOCIATION YEARBOOK 17 (2009), available at http://www.nvca.org/index.php?option=com_docman&task=doc_download&gid=446&Itemid=464 [hereinafter 2009 YEARBOOK].

41. *Id.* at 25-27.

total VC funding in 2008.⁴²

4. A Mature Industry

Although VC financing in its current form is relatively new compared to traditional bank financing and the public equities market, the VC industry is highly organized and well studied. For example, VC managers and their professional advisers formed a trade association named the National Venture Capital Association (“NVCA”). Through the NVCA website,⁴³ one can readily access model legal documents for VC financings that are intended to reflect customary terms. Study of VC investment practices is facilitated by an annual “Yearbook” published by the NVCA that includes statistics dating back to 1980. Key features of the VC industry and VC investment practices discussed in this article have been observed in law reviews or economic journals for decades.⁴⁴

C. *Angel Investors*

Startup companies cannot rely entirely on VC funds for financing, particularly in earlier stages, when funding requests are below minimum VC investment amounts. As a result, entrepreneurs often turn to individual angel investors.

In simple terms, angel investors are wealthy individuals who are not family members or personal friends of a company’s founders. As described below, they differ from VC funds in several key respects.

1. Separate and Direct Investment

Angel investors generally do not rely on intermediaries, such as broker-dealers, to identify or manage investments.⁴⁵ While angel investors increasingly organize into groups and may ultimately invest through a collective entity (for example, an LLC), more often than not, each angel investor participating in a round of financing by a startup company makes a separate investment.⁴⁶ A significant angel round often involves ten or more

42. *Id.* at 26.

43. NAT’L VENTURE CAPITAL ASS’N, <http://www.nvca.org> (last visited Oct. 26, 2010).

44. *See generally* Sahlman, *supra* note 37 (describing customary VC terms during the 1980s).

45. *See* Orcutt, *supra* note 2, at 926-27 (discussing why a viable market for private placement intermediaries does not exist).

46. *See* Ibrahim, *supra* note 14 (noting the prominence of traditional angel investors in the angels market).

separate investors.⁴⁷

This traditional model of individual angel investment can be inefficient. Instead of negotiating with one intermediary, a startup company seeking angel investment must negotiate, communicate, and contract with ten or more separate investors. The parties can mitigate these inefficiencies by designating an informal “lead” investor through whom negotiations are conducted on behalf of other more passive angel investors.⁴⁸ But the effectiveness of a lead investor is limited by its lack of formal authority to act on behalf of each investor.

2. Wealth and Experience

On average, angel investors are wealthy and have experience with entrepreneurial ventures. In a recent study of angel investors, Professor Robert Wiltbank found that the investors had founded on average three ventures over 13 years.⁴⁹ Wiltbank also found that angel investors, while not full-time professional investors like VC managers, did invest in startups frequently. He found that angel investors averaged nine investments in startup companies over ten years and held an average of \$1.3 million of investments spread over six ventures at the time of the study.⁵⁰

The term “angel investor,” however, is sufficiently broad to encompass a wide range of investors. People who have inherited wealth and non-financial professionals, such as lawyers and doctors, commonly invest in startup companies and are fairly included within the definition of angel investors.⁵¹

3. Geography

Angel investors are even less likely than VC funds to invest outside of their local area.⁵² As discussed below, angel investors rely on personal

47. See Goldfarb et al., *supra* note 11, at 10-11 (finding an average of 12.8 angel investors per financing); Andrew Y. Wong, *Angel Finance: The Other Venture Capital* 23 (SSRN Working Paper Series, 2002) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=941228 (finding an average of 12 angel investors per financing).

48. See Ibrahim, *supra* note 10, at 1424 n.89 (recognizing the important role lead investors play in bringing investment opportunities to co-investors); Orcutt, *supra* note 2, at 879 (noting problems that create inefficiency in the angel market).

49. Wiltbank, *At the Individual Level*, *supra* note 11, at 3.

50. *Id.*

51. Orcutt, *supra* note 2, at 877.

52. See Brent Goldfarb, Gerard Hoberg, David Kirsch & Alexander Triantis, *Does Angel Participation Matter? An Analysis of Early Venture Financing*, at 11 (2008), available at

networks to locate investment opportunities, and those networks are likely to be concentrated in the areas where the angel investors live.⁵³

Overall, angel investing is probably less concentrated in high-tech hubs than VC investing, with angel networks or groups emerging all over the country. But areas with significant VC activity are likely to produce more ex-entrepreneurs, and therefore produce more potential angel investors.⁵⁴

D. *Angel Groups*

Angel groups are not altogether new to the angel investing scene, but they have proliferated in recent years. The number of angel groups increased from an estimated 10 in 1996 to an estimated 200 by 2003.⁵⁵ In 2009, there were approximately 300 angel groups in the U.S.⁵⁶

There is a great deal of variation in the organizational form of angel groups. As described below, angel groups differ in how investment decisions are made, the degree to which they rely on professional managers, and their legal structure. The organizational characteristics of angel groups can be understood as lying along a continuum, with a loose affiliation of investors sharing investment opportunities on one end, and a pooled investment vehicle with paid and active managers on the other end. At the latter end of the continuum, angel groups appear similar in form to VC funds.

1. Investment Decision

Members of an angel group may decide to invest on an individual basis after presentation of the investment opportunity to the group.

http://www1.american.edu/academic.depts/ksb/finance_realestate/rhauswald/seminar/angels_napa.pdf (finding that investors are more likely to invest in their own zip code in angel-only deals than in deals involving VC funds).

53. See *infra* text accompanying notes 130-136 (arguing that reliance on personal networks improves angel investing outcomes).

54. See Wong, *supra* note 47, at 10 (finding a correlation between the location of venture capital investments and angel investing within several geographic areas of the United States).

55. SUSAN L. PRESTON, ANGEL INVESTMENT GROUPS, NETWORKS, AND FUNDS: A GUIDEBOOK TO DEVELOPING THE RIGHT ANGEL ORGANIZATION FOR YOUR COMMUNITY 1 (2004).

56. See ANGEL CAPITAL ASS'N, FAQ: THE VALUE OF ANGEL INVESTORS AND ANGEL GROUPS (2009), *available at* <http://www.angelcapitalassociation.org/data/Documents/Public%20Policy/Federal%20Value%20of%20Angels%20FAQ%202009R.pdf> (stating that the Angel Capital Education Foundation lists 300 U.S. angel groups in its database).

Alternatively, members of the group may make investment decisions on a collective basis, for example, by majority vote of members or through an elected investment committee. In a 2003 survey of angel groups by the Center for Venture Research (the “CVR study”), 70% of respondents indicated that their members made investment decisions individually, 23% by majority vote, and 7% through an investment committee.⁵⁷

Involvement of the group members in making investment decisions is contrary to the passive role that investors play in VC funds. For a VC investor, the manager’s expertise in selecting investments is a primary appeal of the investment vehicle. Angel group members, on the other hand, frequently report that they participate in groups to improve their ability to make investment decisions by learning from other group members.⁵⁸ Even in a group that relies on a paid manager, the members typically participate in key points of the investment process, including due diligence investigations of the companies that make presentations to the group.⁵⁹ This active investment model distinguishes an angel group from a small VC fund.⁶⁰

2. Separate or Collective Investment

Closely related to the question of how investment decisions are made is the question of whether members of the group invest collectively or separately. When group members make individual investment decisions, each member may be individually responsible for negotiating the terms of, and monitoring, his or her individual investment. When groups invest by majority vote or by the decision of an investment committee, group members are likely to make a single collective investment through an entity such as an LLC. Angel group members may pool funds for the purpose of making multiple investments within a single collective investment vehicle (like a VC fund), or they may pool funds on an investment-by-investment basis, such as by forming an LLC for each company in which the group invests.⁶¹

57. See PRESTON, *supra* note 55, at 58.

58. *Id.* at 7 (noting that the top two reasons angels invest through groups are “[t]he opportunity to co-invest with other, more experienced investors” and “[t]he opportunity to learn from successful business angels”).

59. *Id.* at 39 (noting that in manager-led groups, “[m]embers are involved at various levels depending on their interests, market or industry expertise, and general desire” and “[m]embers often assist the manager or can lead functional efforts in strategic planning, member relations, or investment identification and selection”).

60. *Id.* at 6 (noting that VC funds operate on a passive investor model where individuals are “not actively involved in the investment decision-making process”).

61. *Id.* at 29-30.

3. Management

Angel groups vary in the degree to which they rely on paid managers. In the CVR study, 61% of respondents reported having paid professional staff.⁶² Both the role of paid staff and the way in which they are compensated, however, vary significantly among angel groups.

In some cases, staff may play a purely administrative role by, for example, coordinating member communications, planning meetings, and managing the group's website and intake procedure for submitting entrepreneurs.⁶³ This article refers to organizations with this type of administrative staff, together with organizations that have no paid staff and that rely entirely on member volunteers, as "volunteer-based groups."

At the other end of the continuum, an angel group manager may be actively involved in a wide variety of functions that appear similar to a VC manager, with the significant distinction that an angel group manager does not make investment decisions. An active angel group manager might screen portfolio company applicants to identify strong candidates and eliminate others from consideration, provide coaching to presenting companies, assist in conducting due diligence for possible investments, and negotiate investment terms on behalf of the group.⁶⁴ This article refers to angel groups that rely more heavily on a paid manager as "actively managed groups."

The administrative staff of a volunteer-based group is likely to receive a relatively modest cash fee that can be funded from member dues, fees collected from presenting companies, and possibly sponsorships from local service providers or other sources.⁶⁵ On the other hand, the manager of an actively managed group may receive compensation that is akin to that received by a VC manager, including a management fee equal to a percentage of committed funds and a carried interest equal to a percentage of any positive return on the investments.⁶⁶

4. Legal Structure

The legal structure of an angel group depends on the angel group

62. *Id.* at 17.

63. *Id.*

64. *Id.* at 17, 44.

65. *See id.* at 38 (discussing sources of revenues to cover administrative support for volunteer-based groups).

66. *See id.* at 24 (citing Washington Dinner Club as an example of an actively managed group that compensates its manager through a management fee and 15% carried interest); *id.* at 39 (indicating that a management fee equal to 2-3% of committed capital and carried interest is typical compensation for an actively managed group).

characteristics discussed above. For example, if the members will rely on managers for purely administrative functions and investors will invest either individually or through an LLC formed for a single investment, the group can be structured as a nonprofit corporation. An executive director can handle operational matters, and administrative staff can be employed by the nonprofit organization.⁶⁷

If the group's manager will have a more active role and will, accordingly, receive a percentage of committed funds and a carried interest, it is more typical to structure the group as an LLC.⁶⁸ This allows for collection of management fees from investors' contributions to the LLC and creation of a carried interest in the LLC's operating agreement.

No single organizational structure dominates the angel group landscape. In the CVR study, 44% of respondents were organized as nonprofit organizations, 38% as LLCs, 9% as corporations, and 7% as informal affiliations without a legal entity.⁶⁹

II. THE CHALLENGES OF STARTUP COMPANY FINANCE

It is a widely held belief that startup companies do not have sufficient funding sources.⁷⁰ This belief is usually expressed in terms of the widening "funding gap" between the amount of capital that a typical entrepreneur can raise from personal resources and the minimum amount that VC funds are willing to invest. Fifteen years ago, the funding gap was believed to range from approximately \$500,000, the point at which friends and family funding was likely exhausted, to \$2 million, the minimum amount that VC funds would then typically invest.⁷¹ But the size of VC funds has increased; thus, they have incentives to deploy their capital more efficiently by making larger investments.⁷² Currently, VC funds do not often make investments below \$5 million.⁷³

67. *See id.* at 20-21 (indicating that a nonprofit structure facilitates the hiring of angel group staff).

68. *See id.* at 35 (indicating that nearly all respondents to the CVR study who reported covering costs by a percentage of committed capital were LLCs and that LLCs are the predominant legal form of angel funds).

69. *Id.* at 26.

70. One source estimates \$60 billion annually in "unmet need for early-stage equity financing." Sjostrom, *supra* note 2, at 3, 6 (citing U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-00-190, SMALL BUSINESS: EFFORTS TO FACILITATE EQUITY CAPITAL FORMATION 1, 2 (2000)).

71. *Participating Securities Hearings*, *supra* note 6, at 54 (statement of Susan L. Preston, Director of Attorney Training and Professional Development, Davis Wright Tremaine).

72. Orcutt, *supra* note 2, at 873-74.

73. *Participating Securities Hearings*, *supra* note 6, at 54.

Some commentators also describe a geographic funding gap due to geographic clustering of VC activity. They believe this leaves entrepreneurs outside those areas without adequate funding opportunities.⁷⁴

It is beyond this article's scope to conclude whether startup companies are in fact underfunded in any absolute sense. The availability of capital for startup companies and returns to investors in startup companies fluctuate over time.⁷⁵ What can be said with confidence is that investing in startup companies involves unique challenges.

A. Poor Candidates for Traditional Financing

Because startup companies typically develop new products, they require substantial capital for research and development activities and expect to direct any cash flow generated in early years of operations to these efforts. Moreover, the assets of a typical startup company primarily consist of intellectual property relating to an unproven product, making the assets difficult to value and highly illiquid. These factors typically prevent startup companies from meeting the underwriting requirements of traditional lenders because they lack both cash flow to service debt and satisfactory assets to secure repayment.⁷⁶

B. Uncertainty, Information Asymmetry, and Agency Costs

Because startup companies are new ventures operating outside of established markets, investing in them involves substantial uncertainty, information asymmetry, and agency costs. These costs limit the pool of investors willing to invest in startups and increase the cost of capital to the entrepreneur.

Uncertainty is inherent in startup companies because their innovative products and business plans are untested at the time of investment.⁷⁷ An entrepreneur will typically have a business plan laying out a strategy for developing and marketing its products, but the plan can be based only on

74. *Id.* at 41-42.

75. In the last decade, the rolling five-year average internal rate of return for VC funds ranged from approximately 48% to 6.5%. 2009 YEARBOOK, *supra* note 40, at 52. Over that period, the capital committed to VC funds ranged from over \$100 billion to less than \$10 billion. *Id.* at 19.

76. Orcutt, *supra* note 2, at 869-70.

77. Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1068, 1076-77 (2003) (noting that the success of a startup company is in large part determined by decisions that have yet to be made, management that has yet to demonstrate its quality, and a technology base that adds scientific uncertainty).

the entrepreneur's best guess about how the products will be received by potential customers and the costs and challenges of establishing the business. Major strategic decisions, such as how to spend company funds, when to seek additional funding, and when to sell or close down the business are necessarily left unmade at the time of funding.

"Information asymmetry" refers to the concept that whatever information is available about the company's prospects at the time of the investment is "soft" (not easily observable by an investor and difficult for an entrepreneur to communicate credibly). In other words, there is an imbalance of information in favor of the entrepreneur. In the face of information asymmetry, an investor will have a difficult time distinguishing between good and bad investments and will discount all the opportunities or price them all as mediocre, thereby raising the cost of capital for high-quality entrepreneurs.⁷⁸

Potential agency costs incurred by investors post-funding also raise the cost of capital to the entrepreneur. Agency costs are a result of uncertainty about the venture and arise because "parties cannot control post-financing behavior by contract because either the behavior itself or future states of the world cannot be verified by third-party arbiters."⁷⁹ This means either the entrepreneur or the investors will have discretion over major future decisions and the opportunity to exercise that discretion in a way that maximizes personal benefits at the expense of the venture. The classic example is the entrepreneur who continues to operate a company that would optimally be sold (either because a positive exit is possible or in order to avoid additional losses) because of personal benefits such as salary or the prestige of running the business.

C. *Patient Capital*

Investments in startup companies are illiquid. There is no ready market for private company stock, and before an exit event, such as an IPO or sale of the company, there is no easy way to value these investments. As a result, an investor in a startup company can expect to wait more than five years for any return on the investment.⁸⁰

D. *Public Funding Programs Struggle*

Addressing the funding gap has emerged as a major public policy

78. Triantis, *supra* note 26, at 307.

79. *Id.*

80. See Wiltbank, *Investment Practices*, *supra* note 11, at 16 (finding an average holding period of 5.8 years for successful angel investments).

initiative at multiple levels of government. A number of government programs seek to subsidize or otherwise “engineer”⁸¹ a market for early-stage finance, but this task has proved difficult.

For example, many states provide tax credits to angel investors. Yet it has been observed that investors in startup companies are not especially sensitive to tax consequences, perhaps because of their “home-run mentality” (i.e., their appetite for investments that are likely to be either total losses or spectacular successes).⁸² It has also been asserted that these tax credits largely benefit investors who would invest without them and are essentially a windfall to these existing investors without any resulting public benefit.⁸³

State governments also maintain programs for investment of public funds in local startups. These programs may take the form of direct investment in startup companies, investment in VC funds committed to funding local companies, or matching funds for local angel groups.⁸⁴ After more than a decade, these efforts have produced mixed results.⁸⁵

At the federal level, public investment in startup companies has historically occurred through small business investment companies (“SBICs”), which are investment vehicles that are operated by private management companies to deploy a combination of private capital and funds from the federal government. Until 2005, the Small Business Administration (“SBA”) operated a Participating Securities Program that was specially designed to facilitate investment in startup companies. In 2004, the federal government ceased licensing new Participating Securities SBICs because the program was expected to result in losses of \$2.7 billion on \$6 billion of federal funding.⁸⁶

81. See generally Gilson, *supra* note 77, at 1069 (using the word, engineer, to describe efforts to duplicate Silicon Valley).

82. Joseph Bankman, *The Structure of Silicon Valley Start-ups*, 41 U.C.L.A. L. REV. 1737, 1764-65 (1994) (noting, but ultimately dismissing, this explanation for why startup companies are structured as potentially tax-inefficient C-corporations).

83. NAT’L GOVERNORS ASS’N CTR. FOR BEST PRACTICES, *supra* note 4, at 9.

84. For example, the Oregon Growth Account invests funds from the Oregon state lottery in VC funds, and at least one angel group structured as a fund, with the intention that those funds will invest in Oregon startups. *Boards and Commissions: Oregon Growth Account Board*, OFF. ST. TREASURER, <http://www.ost.state.or.us/About/OGA> (last visited Oct. 26, 2010).

85. Ibrahim, *supra* note 4, at 16.

86. *Participating Securities Hearings*, *supra* note 6, at 33-36 (Statement of Hector V. Baretto, Administrator, U.S. Small Business Administration); STAEBLER, *supra* note 4, at 1-4.

III. MARKET RESPONSES TO THE CHALLENGES OF FUNDING STARTUP COMPANIES

The above discussion of the funding gap invites the question why anyone would invest in startup companies, but in fact VC funds and angel investors invest an estimated \$40 billion annually.⁸⁷ This part provides a brief summary of prevailing explanations for how VC funds and angel investors navigate the challenges of investing in startup companies.

A. Key Features of VC Financings

1. Preferred Stock

The use of convertible preferred stock in VC financing transactions has been described as ubiquitous. Approximately 95% of VC financings are in the form of convertible preferred stock.⁸⁸

The use of convertible preferred stock sets the financial terms of the VC investment. The terms of preferred stock are negotiated by the parties and do vary somewhat, but a number of key features are almost always present: a liquidation preference equal to at least the amount invested that is triggered upon certain events such as a dissolution, merger, or sale of the company, rights to convert the preferred stock into common stock at the investor's option, and adjustments to conversion rights that protect the investor from the adverse economic effects that could occur if the company later sells stock at a lower price than the investor paid (referred to as "dilution").⁸⁹

Economists believe that these key features of preferred stock create financial incentives that mitigate uncertainty, information asymmetry, and agency costs. For example, the VC fund's liquidation preference is a hurdle that the entrepreneur must clear before sharing in the economic successes of the company. This hurdle makes preferred stock "unattractive to low-quality entrepreneurs" because they will be unsure of their ability to clear the hurdle.⁹⁰ By agreeing to the liquidation preference for the

87. See Orcutt, *supra* note 2, at 876-77 (discussing the amount of angel investment in 2002, 2003, and 2004 based on statistics from The Center for Venture Research (approximately \$21 billion annually) and the amount of VC investment in 2002 based on information from Thomson Venture Economics (approximately \$21 billion)).

88. Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 879 (2003).

89. For example, these terms are reflected in the National Venture Capital Association's model term sheet. NATIONAL VENTURE CAPITAL ASS'N, *Term Sheet*, http://www2.nvca.org/index.php?option=com_docman&task=doc_download&gid=75&Itemid=93 (last updated Feb. 2010).

90. Gilson & Schizer, *supra* note 88, at 887 (explaining the signaling theory but questioning whether it is a complete explanation); see also Orcutt, *supra* note 2, at 893

VC fund, but accepting common stock for themselves, entrepreneurs may be signaling their confidence in their abilities and the business opportunity, thereby reducing uncertainty and information asymmetry.

Signaling theory is just a sample of the many explanations by financial economists and legal scholars for why preferred stock is standard in startup company financings.⁹¹

2. Strong Control Rights

a. Board Representation

It is typical for a VC fund to control at least a substantial minority of a portfolio company's board.⁹² Board representation mitigates agency costs. It provides the VC investor with a monitoring role, while leaving responsibility for day-to-day operations in the hands of the managers (the entrepreneurs), who have superior access to information.⁹³

b. Protective Covenants

VC investment contracts typically include a variety of protective covenants that respond to the challenges of startup company finance. For example, investors may have the right to cause the company to register its stock with the SEC and stock exchanges in order to mitigate illiquidity. Investors may also have the right to buy a portion of any stock offered by the company in the future. This serves to protect against later financings at a lower price that would dilute the investors' stake, thereby mitigating pricing uncertainty.⁹⁴

3. Staging Investments

VC funds typically stage their investment in a startup company, meaning that they invest in multiple installments or tranches spread over

(identifying preferred stock as a mechanism by which VC funds mitigate agency costs).

91. *E.g.*, Triantis, *supra* note 26, at 317-19 (indicating that convertible preferred stock addresses uncertainty and information asymmetry by deferring the decision between rights associated with debt and rights associated with equity and mitigates agency costs because ordinary debt would cause the company to be highly leveraged and would therefore invite risky behavior by the entrepreneur).

92. Dent, *supra* note 5, at 1037-39; Douglas G. Smith, *The Venture Capital Company: A Contractarian Rebuttal to the Political Theory of American Corporate Finance*, 65 TENN. L. REV. 79, 107 (1997).

93. *See* Triantis, *supra* note 26, at 316 (explaining that the entrepreneur is the best party to exploit flexibility in reacting to new information).

94. Dent, *supra* note 5, at 1038-65.

time. In some cases, each tranche is tied to achievement of a specified milestone.⁹⁵ Staging investments mitigates information asymmetry and uncertainty by allowing the VC fund to delay a portion of its investment until it has more information about the company's prospects. It also encourages the entrepreneur to earn the next tranche of funding and therefore mitigates agency costs by discouraging opportunistic behavior.⁹⁶

4. Syndication

VC funds often invest alongside each other in a particular transaction, with one fund serving as the "lead" investor with primary responsibility for due diligence and negotiating investment terms.⁹⁷ Syndication of investments provides a "second set of eyes" on the investment.⁹⁸ Syndication also increases deal flow (i.e., the number of investment opportunities available for consideration by each VC fund) and therefore helps diversify each fund's investments to mitigate risk.⁹⁹

B. Key Features of Angel Financings Compared

The investment practices of angel investors are not as well understood as those of VC funds. For one, angel investors are difficult to study.¹⁰⁰ The failure to identify strong conventions among angel investors is not merely a question of research methodology, however. It also likely reflects the fact that angel investment practices are in fact more varied than those of VC funds.¹⁰¹

Nonetheless, financial economists and legal scholars have been paying increased attention to angel investment practices in recent years, and a clearer picture of those practices is emerging. As discussed below, these studies indicate that angel investors obtain investment terms that are similar to, but ultimately weaker than, the terms received by VC funds.

95. Ibrahim, *supra* note 10, at 1411-12; Orcutt, *supra* note 2, at 891-92.

96. *Id.*

97. Wiltbank, *Investment Practices*, *supra* note 11, at 6-7.

98. *Id.*

99. Ibrahim, *supra* note 10, at n.20.

100. Orcutt, *supra* note 2, at 876 ("Because of the informal and fragmented nature of the U.S. angel market, it is difficult to get specific data on the angel market, or its individual investors.").

101. Orcutt, *supra* note 2, at 878 ("The due diligence process conducted by angels, and the financing terms and conditions they agree to, vary dramatically from one angel to another.").

1. Weaker but Similar Cash-Flow Rights

It is often stated that angel investors are more likely to invest in common than preferred stock.¹⁰² Recent studies, however, suggest that this perception is no longer accurate (if it ever was). A study based on the records of the now-defunct law firm of Brobeck, Phleger & Harrison LLP, for example, found that “angels almost always take preferred shares . . . either investing alone or alongside VC[] [investors].”¹⁰³ Model term sheets for angel-type investments also suggest that preferred stock is typical.¹⁰⁴

Although angel investors usually receive preferred stock, the cash-flow rights associated with that stock are likely to be weaker than those associated with the stock typically issued to a VC fund. For example, the Brobeck study showed that angel investors are less likely to receive cumulative dividend rights,¹⁰⁵ participating preferred stock,¹⁰⁶ redemption rights,¹⁰⁷ and the most beneficial forms of antidilution protections.¹⁰⁸

2. Weaker Control Rights

Angel investors also typically receive weaker control rights than VC funds. For example, angel investors are less likely to have board representation.¹⁰⁹

102. *E.g.*, Ibrahim, *supra* note 10, at 1422.

103. Goldfarb et al., *supra* note 11, at 3.

104. *E.g.*, PRESTON, *supra* note 55, at app. 11.

105. Goldfarb et al., *supra* note 11, at 12. The preferred stock issued by startups rarely pays cash dividends. But it sometimes provides for a cumulative dividend that accrues, but is not paid, over the life of the investment in order to increase the VC fund’s liquidation preference.

106. *Id.* Participating preferred stock entitles the investor to receive not only a liquidation preference equal to the purchase price, but also an additional share of proceeds that would otherwise go to holders of common stock. It is considered a particularly investor-friendly term because it allows the investor to “double-dip” if an event occurs that triggers the liquidation preference.

107. *Id.* at 16. Redemption rights are strong cash-flow rights that also have a substantial control function because exercise of such a right may effectively shut down an underperforming company.

108. Wong, *supra* note 47, at 20 (finding that angels receive antidilution protection less often than VC investors, and are less likely to receive “full ratchet” protection than VC investors).

109. *Id.* at 15 (indicating that board representation was given in only 42.5% of angel financings); Ibrahim, *supra* note 10, at 1423 (citing a study indicating that angel investors in software companies had board representation in only 20% of deals (citing John Freear & Jeffrey Sohl, *The Characteristics and Value-Added Contributions of Private Investors to Entrepreneurial Software Ventures*, 6 J. ENTREPRENEURIAL FIN. 84, 96 (2001))); *see also* Goldfarb et al., *supra* note 11, at 17 (indicating that angel-only financings cede 17% to 20% greater board control to common shareholders than VC deals).

Protective covenants are even more rare in angel financings. For example, one study reported that covenants requiring investor approval of certain actions by management were found in only 5% of angel deals.¹¹⁰

3. Limited Ability to Stage Investment

Angel investors do not typically stage their investments.¹¹¹ Individual angels investing their own funds typically have less ability to make follow-on investments than a VC fund engaged in a continuous fundraising cycle.

C. *Angel Investing Outcomes*

Judging from the discussion above, one might fairly expect that angel investors do not fare well in their investments. They face the same (or worse) problems of uncertainty, information asymmetry, and agency costs as VC funds, but they do not receive the same protections. Yet, two recent studies by financial economists indicate that angel investors and VC funds achieve similar investment results.

Wiltbank tracked investment results among angel investors through surveys of participants in angel groups. He found that nearly two-thirds of angel investment exits resulted in negative returns and that 19% resulted in positive returns. Wiltbank observes that this distribution of outcomes is comparable to studies of VC investments on a project basis (i.e., tracking performance of each portfolio company rather than overall fund performance).¹¹² Overall, Wiltbank estimates an average rate of return of 10% per angel investor¹¹³ and a cash-to-cash multiple of 2.9, a result that Wiltbank describes as “respectable.”¹¹⁴ Wiltbank’s survey results suggest that angel investing is risky, but on average may be “worth it.”¹¹⁵

The Brobeck study considered outcomes for financings involving angel investors only, both angel investors and VC funds, and VC funds only.¹¹⁶ The study found that 31% of companies included in the study were successful (experienced successful liquidity events such as merger or IPO), 28% were surviving (some indication of continued operation but no successful liquidity event), and the remaining 41% had failed (no indication

110. Ibrahim, *supra* note 10, at 1423.

111. *Id.* at 1422.

112. Wiltbank, *At the Individual Level*, *supra* note 11, at 8 (“Broadly, these results resemble the returns of the venture capital projects. . .”).

113. *Id.* at 9.

114. Wiltbank, *Investment Practices*, *supra* note 11, at 19.

115. *Id.* at 18 (citing C.M. Mason & R.T. Harrison, *Is It Worth It? The Rates of Return from Informal Venture Capital Investments*, 17 J. BUS. VENTURING 211 (2002)).

116. Goldfarb et al., *supra* note 11, at 8-9.

of continued operation).¹¹⁷ This distribution was considered roughly in line with general statistics from the VC industry.¹¹⁸

When the authors of the Brobeck study considered the outcomes of angel versus VC financings within their sample data, the results were mixed. The study showed that companies receiving VC funding only in their initial financings were, on balance, more successful (i.e., experienced more mergers and IPOs) than companies receiving angel and VC financing or angel financing only.¹¹⁹ But the study also showed that companies with angel-only financings were significantly less likely to fail than companies receiving VC financing.¹²⁰ Within a subset of transactions involving smaller dollar amounts, the angel-only financings appeared to outperform companies that received VC financing, including a higher rate of successful liquidity events.¹²¹

The methodological challenges of studying angel investing outcomes are admittedly significant. Moreover, in light of poor VC fund performance over some periods of time,¹²² it is not an unqualified ringing endorsement of angel investments to say that they perform about the same as VC funds. These studies of angel investing outcomes, however, should begin to change our perceptions of angel investors as amateurish and lacking bargaining power. At a minimum, the studies indicate that angel investors achieve results that are in the ballpark of those achieved by professionally managed VC funds, in which sophisticated institutional investors invest.

D. How Angels Succeed

How, then, do angels achieve these similar investment results when investing at the high point of information and agency costs and without the strong control rights that VC funds demand? As summarized below, a growing body of literature indicates that angel investors do not simply settle for weaker rights and make do. Instead, their investment terms and strategies are rational responses to the context in which angel investments are made.

117. *Id.* at 14.

118. *See id.* (noting that the success of the firms examined in the Brobeck study closely paralleled the success of the Venture Enterprise firms).

119. *Id.* at 3, 14-15.

120. *See id.* at 14 (cautioning that while statistics show angel-only firms are more likely to survive, this outcome may be explained by a high incidence of “inactive” survival).

121. *Id.* at 15-20.

122. *See supra* note 75.

1. Early Stage

The early stage at which angels invest may be an advantage, rather than a detriment, to angel investors. In his survey, Wiltbank observed that angel investors are more successful when they focus on early-stage companies.¹²³

Investing at earlier stages may provide greater opportunity for angel investors to use their practical experience as entrepreneurs to help new companies. Wiltbank states: “It appears that for these angel investors, a stronger focus on early stage opportunities is not a more dangerous proposition, and may in fact leverage the unique talents of angel investors.”¹²⁴ Thus, while angel investors are less likely than VC funds to negotiate for formal control rights, they are not necessarily passive investors. Wiltbank observed that angel investors spend significant time monitoring financial performance of investments and acting as an informal sounding board for managers of the companies in which they invest.¹²⁵ Wiltbank found that this type of participation is significantly related to a reduction in negative exits.¹²⁶

At least one economist also posits that the smaller investment amounts typically sought by companies at the seed stage leave the company founder with a larger equity stake and a stronger alignment of interests with investors, thereby limiting the need for investors to negotiate for control rights.¹²⁷

Finally, angel investors do not need to deal with an entrepreneur in a heavy-handed way when VC funds will do so in subsequent rounds of investment. If an angel investor has picked a successful company, it is likely that VC investment will follow, and the angel investor can piggyback on the monitoring and control rights of the VC fund. In fact, it is a widely held belief that angel investors risk deterring crucial VC funding if they seek strong control rights that must then be unwound by VC investors.¹²⁸ As Darian Ibrahim stated, “The first reason that angel contract design is financially rational is that angels are the first, but not the last, source of outside funding for start-ups.”¹²⁹

123. See Wiltbank, *At the Individual Level*, *supra* note 11, at 1 (finding that a concentration in early stage investments is linked to fewer failures).

124. *Id.* at 9.

125. *Id.* at 6.

126. *Id.* at 10.

127. Wong, *supra* note 47, at 3-4.

128. Ibrahim, *supra* note 10, at 1430 (citing an angel investor who advises other angels to keep the terms of their investment simple because venture capitalists find complicated and burdensome first round investments unappealing).

129. *Id.* at 1428.

2. Personal Relationships

Angel investors locate investments through a personal “network of trust.”¹³⁰ Angel investors find investment opportunities through friends, angel groups in which they participate, and business associates.¹³¹

Locating investments through personal connections has a number of implications for angel investments. First, it may reduce the information asymmetry that plagues a startup company investing by providing a third-party validation of the entrepreneur’s quality. Simply stated, it is useful to an investor if someone that he or she trusts can vouch for the company founders as honest and capable.

Locating investors within a personal network of trust may also strengthen the threat of reputational sanctions and may therefore reduce agency costs associated with investing in a startup.¹³² An entrepreneur may not want to take advantage of an investor who is a part of the entrepreneur’s personal network.

3. Selective Investment

Because angels invest their own funds and are under no pressure to deploy capital, they can stick to what they know best. For example, Wiltbank observes that angel investors focus within a single area of emphasis, such as computer-related, health-care-related, or non-technology investments.¹³³

4. Organization Into Groups

By organizing into groups, angel investors obtain several benefits.¹³⁴ Participation in a group is essentially a form of syndication, providing that

130. *Id.* at 1432.

131. See Orcutt, *supra* note 2, at 895 (explaining that the “network of trust” is typically derived from business associates, other angels, entrepreneurs from companies formerly financed by the angel, VCs, investment bankers, lawyers and accountants); Wiltbank, *At the Individual Level*, *supra* note 11, at 5 (finding that 40% of respondents located deals primarily through friends and 28% through angel groups).

132. See Ibrahim, *supra* note 10, at 1435-36 (discussing the possibility of a “reputation market” that may reduce agency costs, but concluding that whether such a market has substantial effects is uncertain).

133. Wiltbank, *At the Individual Level*, *supra* note 10, at 4.

134. See *Participating Securities Hearings*, *supra* note 6, at 60 (arguing that angel investors are becoming “professionals” at investing through educational programs and angel group summits); PRESTON, *supra* note 55, at 1 (listing as advantages of angel groups “better investment decisions, enhanced deal flow, the ability to combine funds into larger equity investments, and group social attributes”).

all-important second set of eyes on an investment opportunity and increasing deal flow. Participation in a group also increases deal flow by making angel investors more visible.¹³⁵ An angel group that adopts a fund structure may allow participants to make smaller investments in a larger number of companies, providing diversification. Investing through a group (particularly an actively managed one) can reduce transaction costs by streamlining negotiations, due diligence, and post-investment monitoring.¹³⁶ Finally, groups allow individual investors to share experience and expertise.¹³⁷

IV. REGULATION OF ANGEL INVESTING

A. *The Ban on General Solicitation*

Under the Securities Act of 1933 (the “Securities Act”),¹³⁸ every sale of a security, including the preferred stock that startup companies sell to angel or VC investors, must be registered or must qualify for an exemption from registration.¹³⁹ In the absence of registration or an exemption, a startup company and the individuals who control it may be liable to investors for the full amount of the investment.¹⁴⁰ This can be a particularly harsh remedy because there is no requirement to prove that the purchaser suffered any damage from the failure to register.¹⁴¹

The exemption from registration that most startup companies rely on is Rule 506 of Regulation D (“Rule 506”),¹⁴² which is a safe harbor based on the exemption provided in Section 4(2) of the Securities Act for sales not involving a public offering. Rule 506 is a particularly useful exemption because it preempts most state registration requirements. For a Rule 506 offering, a state can require only a filing fee and a copy of the same “Form D” that must be filed with the SEC.¹⁴³

135. Ibrahim, *supra* note 4, at 744 (“The high visibility of angel groups reduces search costs for entrepreneurs.”).

136. PRESTON, *supra* note 55, at 8 (“The efficiencies of group due diligence . . . cannot be emphasized enough.”).

137. *See id.* at 4, 11 (indicating that angel groups “have the combined manpower for analysis of multiple or complex . . . opportunities,” and that “[h]aving members with different . . . backgrounds can be critical in conducting due diligence”); Ibrahim, *supra* note 4, at 747 (suggesting that a variety of expertise in angel groups improves investment selection and monitoring).

138. Securities Act of 1933, 15 U.S.C. §§ 77a to 77z-3 (2006).

139. *Id.* § 77e.

140. *Id.* § 77o (providing for control-person liability).

141. *Id.* § 77l(a)(1).

142. 17 C.F.R. §§ 230.501-.508 (2009).

143. 15 U.S.C. § 77r (2006); *see also* Sjostrom, *supra* note 2, at 11-12 (describing

The requirements of Rule 506 are, with one major exception, flexible and compatible with conventional startup company financing. There is no dollar limitation on the offering,¹⁴⁴ no limitation on the number of sales to accredited investors,¹⁴⁵ and no specified form of disclosure to accredited investors.¹⁴⁶

One requirement of Rule 506, however, is problematic for startup companies: the ban on general solicitation. The concept of a general solicitation does not expressly appear in the Securities Act. But Rule 506 requires that “neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising.”¹⁴⁷ Through no-action letters, the SEC has indicated that the best way to avoid making a general solicitation is to ensure that the issuer has a “preexisting, substantive relationship” with each potential investor.¹⁴⁸ The SEC has described a substantial preexisting relationship as one that is formed before the offering begins and that “would enable the issuer (or a person acting on its behalf) to be aware of the financial circumstances or sophistication of the persons with whom the relationship exists or that otherwise are of some substance and duration.”¹⁴⁹

The SEC’s ban on general solicitation is more restrictive, or at least different in focus, than the U.S. Supreme Court’s interpretation of Section 4(2) of the Securities Act requires.¹⁵⁰ In *SEC v. Ralston Purina Co.*,¹⁵¹ the Court determined that an issuer’s sale of stock to so-called “key employees”¹⁵² did not qualify for exemption under Section 4(2).¹⁵³ In fact, the group of employees was large, including personnel that the issuer could

preemption under Rule 506 and the perceived advantage of avoiding sometimes disparate state registration requirements).

144. 17 C.F.R. § 230.506 (2009).

145. To qualify as accredited, an investor must satisfy either a net-worth test (\$1 million for an individual) or an annual-income test (\$200,000 individually or \$300,000 with a spouse). *Id.* § 230.501 (2009). Following enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (the “Dodd-Frank Act”), a natural person must exclude the equity in their primary residence from the net worth calculation.

146. 17 C.F.R. § 230.502(b) (2009) (discussing disclosure requirements).

147. *Id.* § 230.502(c).

148. Sjostrom, *supra* note 2, at 13.

149. Mineral Lands Research & Mktg. Corp., SEC No-Action Letter, 1985 WL 55694 (Dec. 4, 1985).

150. Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67, 71–75 (1989) (“The SEC, however, has adopted safe harbor rules that are rather more intrusive than the Supreme Court would mandate.”).

151. 346 U.S. 119 (1935).

152. *Id.* at 120.

153. *Id.* at 127.

not reasonably presume to be financially sophisticated.¹⁵⁴ In reaching its conclusion, the Court rejected the SEC's argument that the offering was directed at too large a number of offerees, and instead based its decision on whether the class of offerees "need the protection of the Act"¹⁵⁵ or instead are able to "fend for themselves."¹⁵⁶ The Court's decision, in other words, focused on the nature of the potential investors to whom the securities were offered, in contrast to the SEC's approach in the Regulation D safe harbor (which focuses on whether there is a preexisting relationship with each offeree).¹⁵⁷

Technically, a preexisting relationship is only one way to avoid a general solicitation under Rule 506. For example, the SEC has determined that the computer matching services and investment symposiums discussed in Part V below do not constitute general solicitations, even though an entrepreneur who participates in those investor forums does not have a preexisting relationship with each investor. Further, it is possible that an investor will approach an entrepreneur without the entrepreneur ever making any solicitation at all, such as when a VC manager learns of an investment opportunity and makes the first overture. Although there is no significant discussion of this situation in SEC precedent, it should not constitute a general solicitation even without a preexisting relationship.¹⁵⁸

Except for those fairly limited situations, however, the preexisting relationship requirement is the predominant framework for interpreting the ban on general solicitation, and it is especially hard on startup companies seeking financing from individual angel investors. To locate the ten or more separate investors necessary for a typical angel round,¹⁵⁹ a company needs to identify a significant number of prospects. These individual angel investors will often be less visible than VC funds.¹⁶⁰ The startup company

154. *Id.* at 121.

155. *Id.* at 125.

156. *Id.*

157. To illustrate the distinction, a startup company should, under *SEC v. Ralston Purina Co.*, be able to offer its stock to the fifty largest venture capital funds in the United States even without any personal connections to those funds. But, that offering would not comply with the substantial preexisting relationship test, and therefore would be suspect under Regulation D. *Cf.* Daugherty, *supra* note 150, at 75 (concluding that an offer to "all red-headed Price Waterhouse partners residing in Chicago" would "pass muster under *Ralston Purina*").

158. In fact, many VC funds regularly (and publicly) solicit business plan summaries from startups through website features and other means. This practice implies an exception to the preexisting relationship requirement when the investor initiates discussions. *See* Ibrahim, *supra* note 4, at 756 (discussing this practice by VC funds).

159. *See* Goldfarb et al., *supra* note 11, at 10-11 (noting that an average angel-only deal includes 12.8 angel investors).

160. *See* Orcutt, *supra* note 2, at 878 (discussing angel investors' preference for anonymity).

itself may have low visibility to potential investors because it lacks significant operations or a fully developed product to market. In this environment, it is unlikely that an entrepreneur will have formed personal relationships with enough qualified investors before financing is needed.

By imposing such substantial limitations on issuers' ability to sell their own securities, the preexisting relationship requirement appears designed to channel sales activities through intermediaries. A number of SEC rules and interpretations reinforce this channeling effect. For example, the SEC allows an issuer to rely not only on its own preexisting relationships but also on the preexisting relationships of intermediaries, such as finders (described below) and registered broker-dealers.¹⁶¹ Moreover, the SEC grants registered broker-dealers substantially more leeway than issuers in how they may form relationships with investors. The SEC has allowed broker-dealers to maintain or supervise the operation of websites that broadly seek out potential investors for the express purpose of establishing preexisting relationships for future offerings.¹⁶² An issuer, in contrast, risks engaging in a general solicitation if it affirmatively seeks out investors for purposes of forming relationships for future offerings.¹⁶³ Finally, a startup company's own personnel could be required to register as broker-dealers if they are involved in sales of the company's securities on a regular basis, thereby increasing the need to outsource these functions.¹⁶⁴

Channeling high-risk investments through expert intermediaries—particularly those subject to registration requirements and oversight by the SEC—does make logical sense from an investor-protection standpoint. Registered broker-dealers and investment advisers have duties to clients that should, in theory, protect investors.¹⁶⁵ There is only one problem: regulated intermediaries are not actively involved with startup investments. Section B below discusses why.

B. Regulation of Intermediaries

In addition to the registration requirements of the Securities Act, there are also regulations that apply directly to intermediaries. These regulations principally include broker-dealer regulations under the Securities Exchange Act of 1934 (the "Exchange Act")¹⁶⁶ and investment adviser regulations

161. Alan J. Berkeley & Alissa A. Parisi, Presentation at ALI-ABA Course of Study on Regulation D Offerings and Private Placements, Questions and Answers About an Issuer's Ability to Obtain Investors in Private Placements, questions 2-10 (2005).

162. IPONET, SEC No-Action Letter, 1985 WL 431821 (July 26, 1996).

163. Berkeley & Parisi, *supra* note 161, question 21.

164. *See infra* text accompanying notes 232–234.

165. *See infra* text accompanying notes 176, 206.

166. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78mm (2006).

under the Investment Adviser Act of 1940 (the “Adviser Act”).¹⁶⁷ The Exchange Act’s and the Adviser Act’s regulation of intermediaries, when combined with the ban on general solicitation, can place startups in a no-win situation.

1. Broker-Dealer Regulation

The paradigmatic broker-dealer is the stockbroker who assists clients in purchasing or selling publicly traded securities for a commission equaling a percentage of the purchase or sale price. The typical stockbroker does not play a significant role in startup company finance because the securities issued by startup companies are highly illiquid and do not trade between investors with any frequency. A small subset of broker-dealers, often referred to as placement agents, specialize in helping startup companies locate investors or assist VC funds in locating investments.¹⁶⁸ However, placement agents who have incurred the expense to register as broker-dealers are not typically involved in the early stages of startup company finance because the transactions are not large enough to generate sufficient commissions.¹⁶⁹

That is not to say that broker-dealer regulations are irrelevant to startup companies. The statutory definition of a broker-dealer¹⁷⁰ is sufficiently broad to potentially include a wide variety of other intermediaries who could play a role in helping raise capital. Third-party finders and computer matching services, for example, have been frequent subjects of SEC no-action letters discussed in detail below.

Outside of these specific contexts, it is difficult to derive from no-action letters and judicial opinions a single, comprehensible framework for evaluating broker-dealer status, and this can become a source of frustration when trying to analyze the regulatory status of new developments like angel groups. Nonetheless, this section reviews the SEC’s general approach to examining broker-dealer status as background for analyzing the regulatory status of angel groups.

167. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2006).

168. See generally JOSEPH BARTLETT ET AL., *ADVANCED PRIVATE EQUITY TERM SHEETS AND SERIES A DOCUMENTS 5-44 to -55* (2003) (providing an example of a placement agent agreement).

169. See American Bar Association, *Report and Recommendations of The Task Force on Private Placement Broker-Dealers*, 60 BUS. LAW. 959, 960 (2005) [hereinafter *Task Force Report*] (indicating that an issuer raising less than \$5 million “will seldom if ever be able to attract attention from fully licensed members of the [National Association of Securities Dealers]”); BARTLETT, *supra* note 168, at 5–55.

170. 15 U.S.C. § 78c(a)(4)(A) (2006).

a. *General Framework*

Under the Exchange Act, a person or entity “engaged in the business of effecting transactions in securities for the account of others” is a broker¹⁷¹ and a person or entity “engaged in the business of buying and selling securities for such person’s own account” is a dealer.¹⁷² Comparable definitions under state law are similar to the federal statute.¹⁷³ Brokers and dealers are referred to collectively using the combined term “broker-dealers.”

Broker-dealers must register with the SEC and be licensed by the Financial Industry Regulatory Authority (“FINRA”), typically by one or more states.¹⁷⁴ Status as a registered broker-dealer subjects the intermediary to a wide range of legal requirements such as competency standards (including exam requirements), recordkeeping requirements, minimum net capital amounts,¹⁷⁵ and obligations to make determinations about the suitability of investments for customers.¹⁷⁶

Under the language of the Exchange Act, two basic questions must be answered in the affirmative to determine that a person or business is a broker-dealer. First, the person or business must be “effecting transactions in securities.”¹⁷⁷ Second, the person or business must be “engaged in the business” of doing so.¹⁷⁸

Courts and the SEC may consider a dizzying number of factors in answering these two questions. For example, one commentator has identified the following activities as potentially indicating that a person or

171. *Id.*

172. *Id.* § 78c(a)(5)(A).

173. For example, the Uniform Securities Act defines a broker-dealer as “a person engaged in the business of effecting transactions in securities for the account of others or for the person’s own account.” UNIF. SEC. ACT § 102(4)(2002).

174. Orcutt, *supra* note 2, at 901-02.

175. *Id.* at 901.

176. See Charles R. Mills et al., *Customer Transactions: Suitability, Unauthorized Trading, and Churning*, in BROKER-DEALER REGULATION 6-1, -3 (Clifford E. Kirsch ed., 2009) (“[A] broker-dealer . . . must have reasonable grounds for believing that the transaction is suitable for the customer’s financial and investment circumstances, needs, and objectives based on the facts, if any, disclosed by the customer.”). Section 913 of the Dodd-Frank Act requires the SEC to conduct studies regarding whether broker-dealers should be subject to the more stringent fiduciary duty imposed on investment advisers. See *Cutting Through the Confusion*, *supra* note 28, at 3-4 (describing heightened legal obligations of investment advisers).

177. Laura S. Pruitt & Wendy B. Hart, *Brokers, Dealers and “Finders”*, in BROKER-DEALER REGULATION, *supra* note 176, at 30-8 to -15; DAVID A. LIPTON, BROKER-DEALER REGULATION §§ 1-38 to -51 (2008).

178. Pruitt & Hart, *supra* note 177, at 30-16 to -19; LIPTON, *supra* note 177, §§ 1-32 to -38.

business is *effecting transactions in securities*: structuring securities transactions, helping identify potential purchasers, screening creditworthiness of securities purchasers, facilitating negotiations of transactions, soliciting securities transactions, facilitating the execution of a transaction or participating in order-taking and order-routing, handling customer funds and securities, and preparing and sending confirmations of securities transactions.¹⁷⁹ The SEC cites the following factors as relevant to whether a potential broker-dealer is *engaged in the business*: “receiving transaction-related compensation; holding one’s self out as a broker, as executing trades, or as assisting others in settling securities transactions; and participating in the securities business with some degree of regularity.”¹⁸⁰ The “regularity of participation” factor has been the basis for determining that an isolated instance of broker-like activity does not satisfy the *engaged-in-the-business* requirement.¹⁸¹

b. Compensation

One particularly prominent factor in the SEC's analysis of broker-dealer status is whether the intermediary receives transaction-based compensation, such as a commission based on the size or success of securities transactions. Because this factor is so important, it is worth considering what constitutes transaction-based compensation and why the SEC cares.

According to the SEC, transaction-based compensation is relevant to broker-dealer status for two separate reasons:

[T]he receipt of transaction-based compensation often indicates that such a person is engaged in the business of effecting transactions in securities. Compensation based on transactions in securities can induce high pressure sales tactics and other problems of investor protection often associated with unregulated and unsupervised brokerage activities.¹⁸²

179. Pruit & Hart, *supra* note 177, at 30-8 to -15.

180. MuniAuction, Inc., SEC No-Action Letter, 2000 WL 291007 (March 13, 2000).

181. LIPTON, *supra* note 177, §§ 1-32 to 1-33 (“Critical to the concept of being engaged in the business of securities transactions is ‘regularity of participation.’”). For example, the SEC has determined that personnel of a corporate general partner would not be a broker-dealer when selling units in the limited partnership on an isolated basis. *Id.* § 1-34 (citing Robinson Res., Inc., SEC No-Action Letter, 1973 WL 6966, at *2 (July 19, 1973)). A small number of transactions, however, may satisfy the regularity-of-participation requirement. *See id.* § 1-35 (citing IDK Ventures, Inc., SEC No-Action Letter, 1990 WL 287029, at *3 (Oct. 18, 1990), in which two sales with the possibility of future transactions constituted regular participation).

182. Persons Deemed Not to be Brokers, Exchange Act Release No. 20943, 30 SEC

The first sentence suggests that transaction-based compensation is relevant as an indication of the true nature of the services being performed. For example, if the metric for determining the amount of compensation is the occurrence of securities transactions, this suggests that the primary purpose of the services is effecting those transactions. The second sentence suggests that transaction-based compensation creates risks to investors that warrant regulatory oversight.¹⁸³

Clearly, receipt of a traditional commission is transaction-based. Receipt of a commission has been described as a “hallmark of a broker-customer relationship.”¹⁸⁴ But any form of compensation that is based on the “number, size or outcome of securities transactions” may be considered transaction-based.¹⁸⁵ For example, the SEC considers a “flat fee” that is subsequently adjusted based on the success of the offering under a “look-back escalator” to be transaction-based.¹⁸⁶

There are forms of compensation that may bear some resemblance to commissions but that have not been fatal to no-action requests. For example, the SEC has granted no-action relief when a third-party assisting an issuer in locating investors received a fee for each questionnaire completed by a potential investor and an additional fee for each investor meeting with the issuer. The fee, however, was not contingent on whether any securities purchases were actually made.¹⁸⁷

In addition, the SEC has granted no-action relief as to broker-dealer status when a person or business receives a management fee based on a percentage of assets under management, similar to the fee received by a VC manager.¹⁸⁸ This conclusion is consistent with the general framework

Docket 618, 622 (May 9, 1984).

183. Orcutt, *supra* note 2, at 908 (“The concept is that transaction-based compensation could induce the finder to engage in abusive or sharp selling practices based on her stake in the outcome of the transaction, which favors the greater regulatory oversight imposed on registered broker-dealers.”).

184. LIPTON, *supra* note 177, § 1-41.13.

185. Pruitt & Hart, *supra* note 177, at 30-17.

186. *Id.* at 30-18 (citing Welton Street Investments, LLC, SEC No-Action Letter, 2006 WL 1896896 (June 27, 2006)).

187. Orcutt, *supra* note 2, 861, 913-15 (discussing Colonial Equities Corp., SEC No-Action Letter, 1988 WL 234557 (June 28, 1988)).

188. McGovern Advisory Group, Inc., SEC No-Action Letter, 1984 WL 45930, at *2 (Sept. 8, 1984) (responding to request of a financial planner). A registered investment adviser managed assets of individuals and employee benefit plans, including making investments on the clients’ behalf in money market accounts and mutual funds. In granting no-action relief as to broker-dealer status, the SEC noted that “compensation to the Company will be based solely upon the value of the assets under management, and will not be determined, directly or indirectly, on a transactional basis or otherwise based on the volume of transactions in securities.” *Id.* See also Dana Investment Advisers, Inc., SEC No-Action Letter, 1994 WL 718968, at *16 (Oct. 12, 1994) (granting no-action relief to

for evaluating compensation described above. At first blush, the management fee might raise the same concerns regarding hard selling practices as a commission. By tying the amount of fees to the amount of assets under management, the fee structure gives the recipient a salesman's stake in increasing the amount of funds placed under management. But, a fee based on the value of assets under management also gives the intermediary an ongoing stake in the long-term performance of the assets because the fee will decrease or increase over time based on long-term performance of the account. By aligning the long-term interests of the intermediary and the client, this type of management fee should pose less risk to an investor than a commission based on price at the time of initial investment. Moreover, a fee based on assets under management does not strongly indicate that the true nature of the services is the sales function of a traditional broker-dealer. For example, the recipient of the fee does not earn more by engaging in a high volume of transactions with the client's funds.

c. Finders

With angel investment amounts typically being too small to attract the attention of registered broker-dealers, startup companies seeking angel financing may turn to unregistered "finders" who locate investors for a fee while trying to limit their activities in accordance with SEC no-action letters to avoid broker-dealer status. There are several thoughtful analyses of the so-called finder exemption, including law review articles,¹⁸⁹ reports of an American Bar Association Task Force,¹⁹⁰ and reports of forums organized by the SEC.¹⁹¹ The current market for finders demonstrates the consequences of restrictive intermediary regulations in the context of startup company finance: low-quality intermediaries operating in an environment of regulatory uncertainty.

No-action letters defining the scope of the finder exemption reflect the following principles:

*Receipt of transaction-based compensation is a strong indicator of broker-dealer status.*¹⁹² The SEC has allowed a finder to

hospital association that introduced its members to an investment fund and received a fee based on a percentage of assets under management by the fund).

189. *E.g.*, Orcutt, *supra* note 2 (discussing the role of finders in private capital markets and proposing a new class of registered finders exempt from broker-dealer regulations).

190. *E.g.*, *Task Force Report*, *supra* note 169 (discussing the regulatory status of finders).

191. *E.g.*, Orcutt, *supra* note 2, at 866-67 (discussing SEC's Annual Government-Business Forum on Small Business Capital Formation).

192. HUGH H. MAKENS, GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL

receive a commission only when the additional restrictions described below are strictly met and the finder activity is an isolated occurrence.¹⁹³

A finder should not be involved in securities transactions frequently. The SEC is hesitant to provide no-action relief to an intermediary with a history of activity as a broker-dealer or that holds itself out as being a securities professional.¹⁹⁴

Finders must play a limited role in transactions. A finder should limit its activities to referring names of investors to the issuer, without becoming involved in structuring terms of the financing, negotiating with purchasers, or making recommendations to investors.¹⁹⁵

Finders who violate these principles could face significant consequences. The commission agreement between the company and the intermediary is likely voidable, and the intermediary risks enforcement actions and civil penalties from state and federal regulators.¹⁹⁶

The consequences to an issuer of using an unregistered broker-dealer are less clear. Commentators have identified theories under which an issuer could face SEC enforcement actions¹⁹⁷ or be liable to investors¹⁹⁸ due

FORMATION, CAPITAL FORMATION: MAKING FINDERS VIABLE 23-25 (2004); Alan J. Berkley & Alissa J. Altongy, *Use and Compensation of "Finders" to Locate Purchasers in Private Placements*, in REGULATION D OFFERINGS AND PRIVATE PLACEMENTS 51, 56 (2000); Virginia K. Kapner, *When Finders Bring Trouble: Avoiding Pitfalls of Working With Unlicensed Broker-Dealers*, 47 BOSTON BAR J. 14, 15 (2003).

193. *E.g.*, Paul Anka, SEC No-Action Letter, 1991 WL 176891 (May 17, 1991) (allowing a famous entertainer to introduce investors to a professional hockey team on the condition that his activities be limited). The SEC has withdrawn, without any helpful explanation, at least one additional no-action letter permitting transaction-based compensation to a finder. Orcutt, *supra* note 2, at 861, 906 (discussing Dominion Resources, Inc., SEC No-Action Letter, 2000 WL 669838 (Mar. 7, 2000)).

194. MAKENS, *supra* note 192, at 27; Berkley & Altongy, *supra* note 192, at 51, 56; Orcutt, *supra* note 2, at 915-16.

195. MAKENS, *supra* note 192, at 25; Berkley & Altongy, *supra* note 192, at 51, 54; Kapner, *supra* note 192, at 14; Orcutt, *supra* note 2, at 906.

196. *See Task Force Report, supra* note 169, at 997-99 (discussing SEC enforcement actions against unregistered broker-dealers and civil remedies under Section 29(b) of the Exchange Act).

197. *See* Orcutt, *supra* note 2, at 925 (discussing the possibility of enforcement actions against issuers for aiding and abetting a violation of Section 15 of the Exchange Act).

198. *See Task Force Report, supra* note 169, at 999 (discussing the possibility that an issuer would be required to repay commissions to investors because the unregistered broker-dealer is an agent of the issuer, and could even be required to refund the entire investment amount because the entire purchase agreement is "part of an illegal arrangement with the unregistered financial intermediary" that is voidable under Section 29(b) of the Exchange Act).

to use of an unregistered broker-dealer. But the SEC has not made a practice of pursuing enforcement actions against issuers simply for use of an unregistered broker-dealer,¹⁹⁹ and case law granting a right of rescission against an issuer for using an unregistered broker-dealer typically involves fraudulent activity or other special circumstances.²⁰⁰ The civil remedies provisions in many state statutes appear broad enough to encompass this type of claim by an investor against an issuer, but reported decisions are not easily found.²⁰¹

This regulatory uncertainty likely affects the quality of finders available to startup companies, at least at the margins.²⁰² A startup company has limited resources to pay a substantial fee that is not tied to successfully raising capital. A startup might be willing to pay a commission because the primary regulatory risk is borne by the finder, but one would expect the most qualified potential finders to apply their talents elsewhere in light of the regulatory risk.

2. Investment Adviser Regulation

The paradigmatic investment adviser provides a client with advice to buy or sell securities or has management discretion over a client's securities account. Investment advisers go by a number of names, such as "money manager," "wealth manager," and "financial planner."²⁰³ These common types of investment advisers do not play a significant role in financing startup companies, perhaps because the cost of locating, investigating, and monitoring investments in startup companies is too high in light of the small investment sizes and the lack of publicly available information about the companies.

But investment adviser regulation is relevant to the financing of startup companies because it potentially applies to managers of investment funds, including VC funds. A fund manager may be viewed as providing investment advice to a fund entity or to individual investors in a fund, although many VC funds escape investment adviser regulation for reasons

199. *Id.* at 998 ("We found no cases where a finder crossed the line into broker-dealer activity for which the issuer was then punished in the absence of such fraud.").

200. *Id.* at 999 (finding "little guidance" on rescission claims against an issuer simply for use of an unregistered broker-dealer).

201. *See id.* at 1003-07 (reviewing uniform acts, treatises, and state case law).

202. *See id.* at 973 ("A concern expressed to the Task Force is that the unregistered financial intermediary makes it very difficult for smaller registered, reputable broker-dealers to become involved in raising funds."); Orcutt, *supra* note 2, at 926 ("[S]ome industry commentators have stated that many of the current breed of Private Placement Finders are of dubious reputation.").

203. *See supra* text accompanying note 32.

described below. As background for analyzing the regulatory status of VC managers and then angel group managers, this Section summarizes the SEC's general approach to determining investment adviser status.

a. General Framework

Under the Adviser Act, an investment adviser must register with the SEC or one or more states.²⁰⁴ Registration as an investment adviser involves substantial disclosure requirements, recordkeeping requirements, the possibility of periodic inspection by the SEC, and limitations on permitted forms of compensation.²⁰⁵ Registered investment advisers also have a fiduciary duty to act in the best interest of a client.²⁰⁶ The regulation of investment advisers is bifurcated between state and federal regulators, with larger investment advisers registering at the federal level and smaller investment advisers registering at the state level.²⁰⁷

The term "investment adviser" is defined in Section 202(a) of the Adviser Act and has been interpreted by the SEC to include a person who "(a) provides advice, or issues reports or analyses, regarding securities or as to the advisability of investing in, purchasing, or selling securities ('investment advice'); (b) provides such services for compensation; and (c) is in the business of providing such services."²⁰⁸ States typically define the term "investment adviser" in a similar manner.²⁰⁹

b. Advice Regarding Securities

"Advice," for purposes of investment adviser status, is construed broadly. The SEC has explained: "A person who makes recommendations about specific securities or who simply provides advice concerning the relative advantages and disadvantages of investing in securities in general

204. 15 U.S.C. § 80b-3 (2006).

205. *Id.* §§ 80b-4 to 80b-5.

206. THOMAS P. LEMKE & GERALD T. LINS, REGULATION OF INVESTMENT ADVISERS 169-70 (2009) (describing obligation to determine that investments are suitable to client's objectives, needs, and circumstances).

207. *See* 15 U.S.C. § 80b-3a (2006) (discussing registration requirement).

208. SEC Staff Legal Bulletin No. 11 (2000), at n.7 [hereinafter SLB No. 11].

209. For example, the Uniform Securities Act defines an investment adviser as:

[A] person that, for compensation, engages in the business of advising others, either directly or indirectly or through publications or writings, as to the value of securities or the advisability of investing in, purchasing, or selling securities or that, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities.

UNIF. SEC. ACT § 102(15) (2002).

is providing investment advice and satisfies the first element.”²¹⁰ For example, the SEC has taken the position that a financial planner who advises individuals or families about allocating assets among certain types of securities and non-security products will likely be deemed an investment adviser, even if he or she does not recommend any particular security.²¹¹

Yet there are a number of securities-related activities that the SEC believes fall outside of even this broad notion of securities advice. For example, the SEC has determined that providing information or data related to securities is not securities advice when: “(1) the information is readily available to the public in its raw state, (2) the categories of information presented are not highly selective, and (3) the information is not organized or presented in a manner which suggests the purchase, holding, or sale of any security or securities.”²¹² Based on this three-prong test, the SEC has determined that operators of financial data services are not investment advisers even when the data is accompanied by software tools that assist professional investors in modeling and analyzing future performance of securities.²¹³

It may also be possible to classify information regarding investments as “educational” and therefore beyond the scope of the Adviser Act. For example, the SEC granted no-action relief to a nonprofit organization, the Missouri Innovation Center, that published a newsletter with a “general education” section including guidance on “how to approach and analyze such investments” and “analyzing financial statements or business plans.”²¹⁴

210. SLB No. 11, *supra* note 208, at n.9.

211. Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act, Release No. IA-1092, 1987 WL 154624, at *38402 n.4 (Oct. 16, 1987).

212. EJV Partners, L.P., SEC No-Action Letter, 1992 WL 372147 (Dec. 7, 1992).

213. *Id.*; see also Wilson Associates, SEC No-Action Letter, 1988 WL 234362 (Apr. 25, 1988) (demonstrating that the SEC emphasizes sophistication of the potential customers, the role of users in selecting which securities to analyze and calculations to perform, the general availability of the formulas, and payment by flat fees not based on the value of an investment portfolio); LEMKE & LINS, *supra* note 206, at 7 (discussing EJV Partners, SEC No-Action Letter, 1992 WL 372147 (Dec. 7, 1992), and Executive Asset Management, Inc., SEC No-Action Letter, 1988 WL 235366 (Dec. 15, 1988)).

214. Missouri Innovation Center, Inc., SEC No-Action Letter, 1995 WL 643949 (Oct. 17, 1995). The Missouri Innovation Center argued that this portion of the newsletter did not constitute securities advice because of its educational nature and because small business capital investments are not a specific type or category of securities. The SEC did not significantly discuss why it granted no-action relief, other than to recite the three-prong test discussed above and to require “strict adherence” to the facts in the letter. *Id.*

c. For Compensation

The SEC construes the *for compensation* component of the investment adviser definition so broadly that it is ordinarily not at issue. The compensation does not need to be in any particular form or even explicitly tied to investment advice.²¹⁵

d. In The Business

The final requirement of the definition—that the adviser be engaged *in the business* of providing advice—has also been construed broadly but has provided some basis for arguing that occasional or incidental investment advice does not require registration. The SEC states that a person is engaged in the business of providing investment advice if it:

- (a) holds itself out as an investment adviser or as one who provides investment advice;
- (b) receives any separate or additional compensation that represents a clearly definable charge for providing advice about securities, regardless of whether the compensation is separate from or included within any overall compensation, or receives transaction-based compensation if the client implements the advice; or
- (c) on anything other than rare, isolated and non-periodic instances, provides specific investment advice, including a recommendation or analysis about specific securities or specific categories of securities.²¹⁶

The SEC has used this test, for example, in considering whether financial advisers to issuers of municipal bonds may occasionally provide advice regarding where to invest proceeds from the bond offering on a short-term basis.²¹⁷ Although the financial adviser might recommend investment in financial products that are securities, these services may not trigger investment adviser registration if the adviser does not advertise these ancillary services and they are provided infrequently and without additional compensation.²¹⁸

215. See SLB No. 11, *supra* note 208, at n.9 (outlining the SEC’s interpretation of the three prong test for investment adviser status).

216. *Id.* at n.11.

217. *Id.* The core service of these advisers is recommending how and when municipalities should issue bonds. The SEC believes that these core services do not require registration because Congress did not intend the Adviser Act to apply to “any person who merely advises issuers concerning the structuring of their financings.” *Id.* at n.12.

218. *Id.* at n.16.

e. Form of Compensation

Form of compensation is an important factor for determining whether a service provider is engaged in the business of providing investment advice. Just as a commission may reveal that a potential broker-dealer is in fact effecting transactions in securities, transaction-based compensation for following investment advice or other forms of compensation that “represents a clearly definable charge” for advice about securities may reveal that the true nature of services is investment advice.²¹⁹

Unlike the broker-dealer context, the SEC does not, in its analysis of investment adviser status, explicitly focus on the potential risks to investors from a particular form of compensation. The Adviser Act and the SEC, however, are not altogether silent on the incentives created by different forms of investment adviser compensation. Section 205(a) of the Adviser Act generally prohibits registered investment advisers from receiving a performance fee based on “a share of capital gains” or “capital appreciation of the funds” in the client’s account.²²⁰ As described below, the prohibition on performance fees is based on a perception that they potentially harm investors.

Performance fees are described as creating a situation in which it is “heads I win, tails you lose” for the adviser.²²¹ This is because an adviser receiving a performance fee does not fully internalize the cost of large negative returns and therefore may have an incentive to engage in riskier investments.²²² When receiving a performance fee, for example, a total loss on an investment will not have a direct negative consequence to the adviser, at least not one that is worse than a break-even investment. In contrast, a total loss on an investment directly reduces a fee based on the total value of assets under management.

A related concern about performance fees is that they may cause an adviser to time transactions in self-serving ways.²²³ For example, an adviser may want to lock in gains at a particular time to secure his or her fees based on personal needs, even when holding the investment would be more advantageous to the client’s long-term goals.

Despite these potential risks, the prohibition is not absolute. For example, Section 205(b)(3) of the Adviser Act provides that the manager of

219. *Id.* at n.17.

220. 15 U.S.C. § 80b-5(a)(1) (2006).

221. LEMKE & LINS, *supra* note 206, at 152.

222. *See id.* (explaining the concern that advisers could speculate with client assets to earn advisory fees).

223. *See id.* at 152-53 (describing the possibility of advisers timing transactions when compensation is based on capital gains or appreciation).

a “business development company” may receive a performance fee.²²⁴ The definition of a business development company is intended to cover the typical VC fund. To qualify, a fund must be engaged in the business of investing in and providing “managerial assistance” to privately held companies or other issuers for which traditional equity financing is difficult to obtain.²²⁵ A performance fee under Section 205(b)(3) must not exceed 20% and must be net of realized losses in the fund’s portfolio.²²⁶

The requirements of Section 205(b) are responsive to the concerns that normally accompany performance fees. First, the requirement that gains be calculated net of losses helps alleviate the “heads I win, tails you lose” incentives that might otherwise be created by a performance fee; any losses from bad investments are set off against the gains from good investments so that the fund manager is internalizing the downside of risky investments. The risk of manipulative timing is also reduced in the context of a business development company because investments by VC funds are highly illiquid, so the fund manager has little control over the timing of exiting an investment. Finally, the fact that business development companies must provide substantial managerial assistance to the companies in which they invest also ensures that a fund manager will internalize the risk of each investment. A fund manager who spends substantial time screening, monitoring, and managing an investment will have wasted valuable time if that investment fails to generate any gains. The same magnitude of opportunity cost may not be incurred by the manager of a portfolio of publicly traded stocks that are relatively easy to buy, sell, and research from publicly available sources.

Another exception to the prohibition on performance fees is based on the sophistication of the individual clients. Rule 205-3 under the Adviser Act allows an investment adviser to charge a performance fee to “qualified clients”²²⁷ who meet wealth standards and are presumed to be sophisticated.

Although the law of performance fees is not, according to a strict reading of the SEC’s guidance, an explicit component of evaluating investment adviser status, one can reasonably expect that the SEC will interject concerns about risks to investors in its analysis of investment adviser status, as it has in evaluating broker-dealer status. Accordingly, when this article evaluates the investor adviser status of angel group managers in Part V below, it considers both what the form of their compensation indicates about the true nature of their services and whether the compensation poses any special risk to investors.

224. 15 U.S.C. § 80b-3 (2006).

225. *Id.* § 80a-2(a)(48).

226. *Id.* § 80b-3.

227. 17 C.F.R. § 275.205-3 (2009).

3. VC Fund Regulation

Like conventional broker-dealers and investment advisers, VC funds act as financial intermediaries.²²⁸ A number of regulatory schemes are potentially applicable to those activities, including the investment adviser and broker-dealer regulations described above and the Investment Company Act of 1940 (the “Investment Company Act”).²²⁹ VC funds, however, often escape substantial regulation as intermediaries through a combination of statutory exemptions secured by the VC industry through lobbying efforts, regulatory exemptions based on the SEC’s deference to VC activities, and belief by some VC managers that their activities are sufficiently different from conventional intermediaries that they are outside of the scope of the regulatory schemes.

a. Investment Company Act

Traditional mutual funds through which most Americans invest in the public equities markets are registered as “investment companies” with the SEC and are subject to substantial regulation under the Investment Company Act. The Investment Company Act might seem like a natural framework for regulating VC funds, which also pool capital of individual investors for professional management. The disclosure and other requirements of the Investment Company Act are viewed as incompatible with the operations of a typical VC fund, however, and VC funds have an easy time avoiding regulation under the Investment Company Act. A fund is not required to register under the Investment Company Act if it has fewer than 100 investors or if all investors are “qualified purchasers” owning at least \$5 million in investments.²³⁰ Typically, a VC fund can and does work within these limitations and avoids regulation under the Investment Company Act.²³¹

b. Broker-Dealer Status

Although VC managers facilitate securities transactions by bringing together startup companies and institutional capital, they are generally not subject to broker-dealer regulation probably because of the “issuer exemption” from the definition of a broker-dealer. An issuer selling its own securities is not a dealer because it does not typically both sell and buy

228. Triantis, *supra* note 26, at 307-19.

229. 15 U.S.C. §§ 80a-1 to -64 (2009).

230. *Id.* at §§ 80a-3(c)(1), 80a-3(c)(7).

231. HALLORAN, *supra* note 25, at 5-3 to -4.

securities (it only sells securities) and is not a broker because it does not sell securities *for the account of others*.²³² The issuer exemption is defined through no-action letters²³³ and a safe-harbor rule²³⁴ that describe the extent to which personnel of an issuer can be involved in securities transactions without becoming broker-dealers.

The issuer exemption most clearly applies when a VC manager is involved in “downstream” sales of fund interests to VC investors.²³⁵ The sale of fund interests is viewed as a sale by the fund, not by the manager acting “for the account of others.”²³⁶ The ongoing management responsibilities of the fund manager support this interpretation. The SEC has recognized that a bona fide general partner of a limited partnership with ongoing management responsibilities may take advantage of the issuer exemption when selling interests in the limited partnership.²³⁷ VC funds easily fit within this framework because they are typically structured as limited partnerships with the VC fund manager serving as the general partner and the VC investors as limited partners.²³⁸

There is also a theoretical issue about whether a VC manager is a broker by virtue of “upstream” purchases of securities of portfolio company stock on behalf of the VC fund. Conceptually, the purchase of portfolio company securities is the mirror image of the downstream sale of fund interests to investors and should therefore also fall outside the statutory broker-dealer definition under what could be called the “purchaser exemption.”²³⁹

c. Investment Adviser Status

The more difficult question for VC fund managers has been whether they must register under the Adviser Act as advisers to either the fund

232. LIPTON, *supra* note 177, § 1-38 (quoting the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(4) (2006)).

233. *Id.* §§ 1-42.2 to 1-42.3.

234. 17 C.F.R. § 240.3a4-1 (2009).

235. *Cf.* SHARTSIS FRIESE LLP, *supra* note 30, at 241-45 (identifying Rule 3a4-1 and no-action letters as a basis for claiming that hedge fund advisers and their personnel are not broker-dealers).

236. LIPTON, *supra* note 177, §§ 1-38 (quoting the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(4) (2006)).

237. Partners in Housing, SEC No-Action Letter, 1972 WL 7622 (Dec. 29, 1972); DeMatteis Development Corp., SEC No-Action Letter, 1971 WL 6492 (Sept. 2, 1971).

238. HALLORAN, *supra* note 25, at 5-8 to -10.1.

239. Even more theoretical is the possibility that the fund is a “dealer” of securities. Even in the context of hedge funds, which buy and sell a large volume of securities and therefore could more likely be viewed as dealers, dealer status is not a major concern. SHARTSIS FRIESE LLP, *supra* note 30, at 246-47.

entity or the individual investors in a fund. VC fund managers typically do not register under the Adviser Act, either because they take the “non-adviser” approach of arguing that they do not come within the definition of an investment adviser or because they rely on the “private adviser exemption” for advisers to fewer than 15 clients.

Under the non-adviser approach, VC fund managers argue that there is no traditional client-adviser relationship between the VC fund manager and either the VC investors or the fund entity. They point out that the VC manager has complete control of the VC fund and a VC investor has no right to make investment decisions regarding the portfolio companies or to even withdraw from the fund at regular intervals. In other words, once formed, the fund is an internally managed entity with the fund manager directing its activities in its role as general partner, rather than a client relying on the advice of a third-party adviser.²⁴⁰ The non-adviser approach has support in case law holding that the trustee of an investment trust does not come within the definition of an investment adviser because a trustee “acts himself as principal” on behalf of the trust rather than “advis[ing] the trust corpus.”²⁴¹

In the case of *Abrahamson v. Fleischner*,²⁴² the Second Circuit arguably called into question the non-adviser approach by holding that the general partner of an investment partnership was an investment adviser to the partnership entity and potentially to the individual limited partners who invested in the fund. Despite the *Abrahamson* case, VC managers may continue to take the non-adviser approach by distinguishing the operation of a VC fund from the investment partnership at issue in *Abrahamson*. VC managers have emphasized that the *Abrahamson* partnership provided an annual withdrawal right so that investors had some ability to “reject” the advice of the general partner based on periodic performance reports. VC fund managers have also tried to distinguish their activities from the facts of the *Abrahamson* case by emphasizing a VC manager’s ongoing role in providing managerial assistance to portfolio companies, as opposed to the partnership in *Abrahamson*, which made more passive investments often in publicly traded securities.²⁴³ Since the *Abrahamson* case, SEC staff has questioned in at least one no-action letter the case law regarding investment trusts that was previously thought to support the non-adviser approach, but the SEC (the agency itself, rather than the staff acting through no-action letters) has not taken a formal position on the continuing

240. HALLORAN, *supra* note 25, at 5-72 to -74.

241. *Id.* § 5-74 (quoting *Selzer v. Bank of Bermuda, Ltd.*, 385 F. Supp. 415, 420 (S.D.N.Y. 1974)).

242. 568 F.2d 862 (2d Cir. 1977).

243. HALLORAN, *supra* note 25, at 5-73 to -74.

validity of the non-adviser approach.²⁴⁴

A VC manager that is unwilling to accept the uncertainties of the non-adviser approach can currently rely instead on the “private adviser exemption” from Adviser Act registration requirements. Under the private adviser exemption, an adviser to fewer than 15 “clients” is not required to register under the Adviser Act.²⁴⁵ VC fund managers can rely on this exemption because Rule 203(b)(3)-1 under the Adviser Act²⁴⁶ designates the fund entity itself, and not each VC investor, as the client. Therefore, a VC manager can manage up to 15 separate funds under the private adviser exemption.²⁴⁷

Similarly, Congress enacted a statutory provision in 1980, shortly after the *Abrahamson* case, providing that a business development company (a definition that would encompass most conventional VC funds)²⁴⁸ counts as only a single client for purposes of the private adviser exemption.²⁴⁹ The special treatment of business development companies was a result of lobbying efforts by the VC fund industry in reaction to the *Abrahamson* case.²⁵⁰

The recently enacted Dodd-Frank Act²⁵¹ eliminates the private adviser exemption effective July 21, 2011.²⁵² The new law, however, specifically exempts VC managers from registration under the Adviser Act. Other recent SEC rules aimed at hedge funds²⁵³ also contain exemptions intended to benefit VC funds.²⁵⁴ These exemptions appear to recognize the

244. *Id.* § 5-74 (citing SS Programs Ltd., SEC No-Action Letter, 1974 WL 10963 (Oct. 17, 1974)).

245. 15 U.S.C. § 80b-3(b)(3) (2006).

246. 15 C.F.R. § 275.203(b)(3)-1 (2009).

247. The rule is conditioned on two requirements: (a) that the manager does not tailor investment advice to the objectives of individual VC investors and (b) that VC investors are not otherwise investment adviser clients of the VC manager. *Id.*

248. *See* Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(48) (2006) (defining “business development company”); HALLORAN, *supra* note 25, at 5-30 to -32 (describing the managerial assistance requirement associated with business development companies).

249. HALLORAN, *supra* note 25, at 5-75 to -76.

250. *Id.* § 5-75 (“To resolve the uncertainty, the venture capital industry was able to persuade Congress to add in the 1980 Amendments to the 1940 Act a definition of ‘business development company’ (‘BDC’) to the Advisers Act . . . together with an amendment to the Act’s private adviser exemption.”).

251. *See supra* note 145.

252. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

253. *See, e.g.*, Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act, Release No. IA-2333, 2004 WL 2785492 (Dec. 2, 2004) (including rules requiring hedge fund managers to register that were overturned by *Goldstein v. Securities & Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006)).

254. HALLORAN, *supra* note 25, at 5-81 (discussing proposed Rules 216 and 509 under the Adviser Act, and the SEC’s statements in the adopting release that business development companies are exempted due to their important role in financing small businesses).

importance of VC funds to small capital formation²⁵⁵ and reflect a perception that VC funds present less risk to investors than do hedge funds.²⁵⁶

On the whole, then, the SEC's approach to regulating VC funds is cautiously deferential. While SEC staff has resisted the non-adviser approach, special exemptions from registration requirements do accord favorable status to VC funds.

V. REGULATION OF INVESTOR FORUMS

The organization of angel investors into groups potentially raises new issues under securities regulations described above.²⁵⁷ For example, a startup company that presents to an angel group does not likely have a substantial preexisting relationship with each member of the group. Does this mean that presenting to an angel group is a "general solicitation" that disqualifies the company from relying on Rule 506? And if angel groups are playing an intermediary role similar to VC funds, broker-dealers, or investment advisers, then do the regulatory schemes that apply to those intermediaries also apply to angel groups and their managers?

Despite the rapid growth in angel groups, the SEC has not provided significant guidance on this topic. In 2002, an angel group, the Gulf Coast Venture Forum ("GCVF"), did request no-action relief on the question whether the organization was required to register under the Adviser Act.²⁵⁸ The SEC declined to answer the question because GCVF's request "[did] not contain adequate facts and legal analysis to enable us to evaluate it thoroughly."²⁵⁹ The SEC did note, however, that even if GCVF fell within the definition of an investment adviser, registration at the federal level would be required only if GCVF had \$30 million in assets under management due to provisions of the Adviser Act that leave regulation of small advisers to the states.²⁶⁰ The SEC indicated that GCVF, which did

255. *Id.*

256. *Id.* §§ 5-78 to -79 (citing adopting release for the hedge fund rules).

257. *See supra* text accompanying note 19 (summarizing commentary discussing whether angel groups violate the ban on general solicitation and trigger broker-dealer registration requirements).

258. Gulf Coast Venture Forum, Inc., SEC No-Action Letter, 2002 WL 1917285 (Aug. 21, 2002).

259. *Id.* at *1.

260. *Id.* *See also* 15 U.S.C. § 80b-3a (2006) (explaining which advisers are subject to state authorities and setting a floor of \$25 million in asset management before requiring registration with the SEC, with one noted exception). Effective July 21, 2011, Section 410 of the Dodd-Frank Act increases the threshold for federal registration to \$100 million, except when an adviser is not subject to registration and examinations in its home state or would be required to register with more than 15 states.

not pool funds and left investment decisions to individual investors, appeared to have no assets under management. Therefore, the SEC concluded that GCVF should register with the state in which it maintained its principal place of business if it came within the definition of an investment adviser.

The GCVF no-action letter leaves many unanswered questions. It does not address the general solicitation question or broker-dealer status. It also does not answer whether GCVF fell within the definition of an investment adviser, which would be instructive not only under the Adviser Act but also for purposes of similar state law definitions and registration requirements.²⁶¹

Without any definitive statement by the SEC regarding the regulatory status of angel groups, it is necessary to piece together an analytical framework by looking to the general principles discussed above and the closest analogous situations that have been analyzed by the SEC. In this case, two different forms of “investor forums” are a logical starting point: computer-based matching services and investment symposiums.

A. *Intermediary Status*

Angel Capital Electronic Network (“ACE-Net”) is a key no-action letter addressing whether organizers of an Internet-based matching service were required to register as broker-dealers or investment advisers.²⁶² ACE-Net was created by the SBA to connect accredited investors with entrepreneurs seeking financing. The network was to be operated by local nonprofit entities and universities. It included a search engine that would allow investors to search for companies in certain industries or in other potential areas of interest, such as offerings of a certain size or minority-owned businesses.²⁶³

In determining that ACE-Net was not required to register as a broker-dealer, the SEC emphasized that ACE-Net and the local operators did not:

Provide advice about the merits of particular investments.

Participate in negotiations for transactions between participants.

Receive compensation from ACE-Net users other than flat fees to cover administrative costs (which were not contingent on the

261. See UNIF. SEC. ACT § 102(15) (2002) (defining and discussing the scope of the term “investment adviser”).

262. Angel Capital Electronic Network, SEC No-Action Letter, 1996 WL 636094 (Oct. 25, 1996).

263. *Id.*

completion of any transactions).

Hold themselves out as providing securities-related services other than operating ACE-Net.²⁶⁴

In determining that ACE-Net was not required to register as an investment adviser, the SEC cited only the first two points.²⁶⁵ Other no-action letters considering whether a matching service is an investment adviser have focused on compensation issues as well. In one such letter, the SEC noted that the network operators received only administrative fees, and further noted that employees involved in the network's operation received only salaries commensurate with providing administrative services.²⁶⁶

B. *General Solicitation*

Texas Capital Network, Inc., is a key no-action letter concerning whether use of a matching service constitutes a general solicitation by a participating entrepreneur. It involved a matching service similar to ACE-Net operated by Texas Capital Network, Inc. (the "Network"). The SEC determined that use of the service was not a general solicitation.²⁶⁷

The Michigan Growth Capital Symposium no-action letter closely followed the logic of the computer matching service letters in considering a context that may be even more analogous to angel groups. At issue was a symposium sponsored by the University of Michigan and organized by the director of a university program for studying private equity investing (the "Director"). It was an annual event attended by selected entrepreneurs, VC managers, and other observers such as attorneys, accountants, and representatives of state or local governments. The symposium allowed entrepreneurs (selected and coached by the Director) to make a 12-minute presentation to potential investors. The SEC determined that presenting to the symposium was not a general solicitation.²⁶⁸

264. *Id.*

265. *Id.*

266. Technology Capital Network, Inc., SEC No-Action Letter, 1992 WL 175694 (June 5, 1992).

267. Texas Capital Network, Inc., SEC No-Action Letter, 1994 WL 52739 (Feb. 23, 1994); *see also* Arizona Capital Network, Inc., SEC No-Action Letter, 1998 WL 191395 (Apr. 21, 1998) (granting no-action relief but indicating that unrestricted generic advertising may constitute a general solicitation); Colorado Capital Alliance, Inc., SEC No-Action Letter, 1995 WL 271123 (May 4, 1995) (granting relief for core matching services but indicating that the SEC was without sufficient detail to express any view regarding seminars and educational programs).

268. Michigan Growth Capital Symposium, SEC No-Action Letter, 1995 WL 264883 (May 4, 1995).

Read together, the matching service and symposium no-action letters are a substantial departure from the SEC's customary interpretation of what constitutes a general solicitation. The letters do not reference any preexisting relationship between participating entrepreneurs and participating investors (or any such relationship among participating investors). In fact, the whole purpose of these forums was to engineer encounters between investors and entrepreneurs in markets where adequate relationships do not currently exist.

The matching service and symposium no-action letters do, however, imply limits on the operation and design of an investor forum. Based on the facts cited in the letters, they can be read as requiring four primary features: that investors be accredited or otherwise sophisticated, that advertising or publicity be limited to the forum as a whole without reference to individual investments, that organizers of the forum play a limited role in effecting specific investments, and arguably that the forum serve some economic development purpose beyond generating profits for individual participants.

1. Accredited or Sophisticated Investors

The matching service no-action letters consistently emphasize that only accredited investors, or investors who have otherwise been determined to be sophisticated, may participate.²⁶⁹ The symposium no-action letter emphasizes that mailings promoting the forum would be directed only to known accredited investors.²⁷⁰

The requirement that all investors in a matching service or symposium be accredited or sophisticated is consistent with the Court's holding in *Ralston Purina* that an offering is private if it is directed only at offerees who can "fend for themselves" and do not need the protection of a registration process.²⁷¹ One (although not the only) measure of whether an investor requires the protection of registration is the investor's financial sophistication.²⁷² Accredited investor status, which is based on net worth and income standards, is a proxy for financial sophistication based on the assumption that wealthy investors are sophisticated or can obtain sufficient advice to protect their interests.²⁷³

269. Arizona Capital Network, Inc., *supra* note 267; Colorado Capital Alliance, Inc., *supra* note 267; Texas Capital Network, Inc., *supra* note 267.

270. Michigan Growth Capital Symposium, *supra* note 268.

271. Daugherty, *supra* note 150, at 74 (interpreting *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953)).

272. *Id.* at 76.

273. Donald C. Langevoort, *Angels on the Internet: The Elusive Promise of "Technological Disintermediation" for Unregistered Offerings of Securities*, 2 J. SMALL &

2. Limited Advertising

The no-action letters are clear in providing that advertising of an investor forum should be “generic,” meaning that it does not reference a particular investment opportunity.²⁷⁴ A public reference to a specific investment opportunity would be inconsistent with the ban on general solicitation because it would reach a broader audience than the investors who have been qualified to participate.

The no-action letters make reference to a further limitation on the scope of advertising, but the scope of this limitation is a mystery. The SEC has indicated that “unrestricted advertising” may constitute a general solicitation, even if advertisements do not reference specific investments.²⁷⁵ But the SEC has permitted advertisements in widely circulated periodicals such as *Venture Journal*²⁷⁶ and in newspapers.²⁷⁷

3. Limited Role of Forum Organizer

Even in the no-action letters addressing general solicitation, rather than intermediary status, the limited role of the matching service and symposium organizers figures prominently in the SEC’s analysis.

In Texas Capital Network, the SEC emphasized that information in the computer database was derived from questionnaires without investigation of the information by the Network. The SEC also noted that the merits of potential investments were not assessed by the Network, and the Network did not assist in formulating the terms of investments. The Network received only “nominal administrative processing fees.”²⁷⁸

The Michigan Growth Symposium letter is more permissive than the matching service letters, allowing the Director to play a more active role than the matching service operators. The Director apparently screened, selected, and even coached presenting companies. Perhaps the SEC allowed this expanded role because it recognized that a screening function

EMERGING BUS. L. 1, 22 (1998) (indicating that “under Regulation D we presume sophistication from status with respect to accredited investors” but questioning this approach).

274. *E.g.*, Arizona Capital Network, Inc., *supra* note 267; Colorado Capital Alliance, Inc., *supra* note 267; Texas Capital Network, Inc., *supra* note 267.

275. *E.g.*, Arizona Capital Network, Inc., *supra* note 267 (finding that certain features of a matching service would not constitute a general solicitation, but stating that unrestricted distribution of certain advertising may constitute general solicitation); Colorado Capital Alliance, Inc., *supra* note 267 (failing to provide no-action relief with respect to the proposed form of advertising).

276. Michigan Growth Capital Symposium, *supra* note 268.

277. Texas Capital Network, Inc., *supra* note 267.

278. *Id.*

was necessary for an in-person symposium, unlike an Internet-based matching service that can accommodate an almost unlimited number of companies and investors. In addition, the SEC might have believed that the in-person symposium presented less risk to investors because its participants were likely to be drawn primarily from the Director's and other organizers' personal network of contacts and because an in-person event imposed a natural limit on the reach of the event. But even with this more permissive approach, the symposium letter was clear that the Director would not be making recommendations to investors, would not be involved in negotiations between investors and companies, and would receive administrative fees only.²⁷⁹

Unlike the SEC's emphasis on investor status and advertising—which are typical factors in a general solicitation analysis—it is not obvious what the limited role of an investor forum operator has to do with whether a general solicitation has occurred. Thinking broadly, however, the investor forum letters are not the only example of when reliance on an intermediary is relevant to whether a general solicitation has occurred. As discussed above, a registered broker-dealer can form preexisting relationships in ways that issuers may not, such as through a website and questionnaire.²⁸⁰ Presumably, the SEC believes that reliance on a registered intermediary may sufficiently improve an investor's ability to assess an investment opportunity that the ban on general solicitation (and the preexisting relationship requirement in particular) may be relaxed. The investor forum letters can be read as standing for the related proposition that reliance on an *unregulated* intermediary may hamper an investor's ability to assess an investment opportunity and may require more rigorous application of the general solicitation restriction. In this regard, the concept of a general solicitation is not limited to its more literal connotation of depending on the scope of the offering (i.e., how selective or indiscriminate the issuer was in selecting potential investors), but rather is a more flexible concept that can be relaxed or enforced more strictly based on other facts and circumstances bearing on whether offerees require the protections of registration.

Repeating the factors cited in the intermediary no-action letters is consistent with this interpretation. It is less likely that the forum operator is acting as a harmful, unqualified intermediary if it receives administrative fees only and is expressly prohibited from key activities such as advising on the merits of transactions.

Other facts emphasized in the general solicitation letters further establish that the forums were investor-led rather than a service provided to passive investors seeking investment advice from the forum operator. In

279. Michigan Growth Capital Symposium, *supra* note 268.

280. Berkeley & Parisi, *supra* note 161.

the matching service letters, entrepreneurs did not receive unrestricted access to investors. Instead, investors determined whether to contact the entrepreneurs based on a summary of a business plan.²⁸¹ In the symposium letter, the SEC emphasized that private placement memoranda including actual investment terms were not distributed at the event. Instead, the participating investors heard brief presentations and then made their own decision whether to approach entrepreneurs to discuss investment terms.²⁸²

In sum, the SEC seems to care not only that participants in an offering are capable of fending for themselves but also that investors are aware that they should be relying on their own capabilities rather than unregulated (and potentially unqualified) intermediaries.

C. *Nonprofit Status and Economic Development*

Involvement of nonprofit organizations or educational institutions is a common thread through the investor forum letters.²⁸³ In fact, the matching service no-action letters have been described as applying only to services operated by nonprofit entities.²⁸⁴ This interpretation has some basis in the SEC's no-action letters. For example, the SEC declined no-action relief to a for-profit entity that sought to operate an Internet-based matching service in substantial conformance with the ACE-Net no-action letter.²⁸⁵ The SEC viewed the proposed service as more similar to prequalification sites operated or supervised by broker-dealers that seek to establish qualifying relationships with potential investors for future offerings.²⁸⁶ The SEC has allowed these prequalification sites only when a registered broker-dealer is involved (presumably to conduct a more rigorous suitability determination than merely establishing accredited investor status) and only when protections are in place to ensure that the service does not become a conduit for a particular offering.²⁸⁷

The basis for distinguishing between for-profit and nonprofit entities in the investor forum letters is not clear and may have shifted over time. In

281. Texas Capital Network, Inc., *supra* note 267.

282. Michigan Growth Capital Symposium, *supra* note 268.

283. *E.g.*, Angel Capital Electronic Network, *supra* note 262 (involving nonprofit entities and educational institutions); Michigan Growth Capital Symposium, *supra* note 268 (involving an educational institution); Texas Capital Network, Inc., *supra* note 267 (regarding a nonprofit corporation).

284. Raymond, *supra* note 19, at 1-12.

285. Progressive Technology Inc., SEC No-Action Letter, 2000 WL 1508655 (Oct. 11, 2000).

286. *Id.*

287. *See* IPONET, *supra* note 162 (finding that posting notices of private placements to a password-protected website operated in conjunction with a registered broker-dealer was not general solicitation); Berkeley & Parisi, *supra* note 161.

one early investor forum letter, the SEC granted no-action relief to a computer matching service operated by Venture Capital Network, Incorporated (“VCN”), because it determined that VCN was not in the “business” of issuing reports or providing analysis of securities.²⁸⁸ The SEC then cited a dictionary definition of the word “business,” which included activities undertaken for “profit or gain.”²⁸⁹ VCN did not meet the dictionary definition of a business because it had no employees, and the only people actually receiving any compensation for administering the service were employees of a governmental body that cosponsored the service (who could not be regulated in their roles as government employees).²⁹⁰ This letter could be read broadly to prohibit any personal financial gain in connection with a matching service.

More recent no-action letters do not rest on the cited definition of a business and are not limited to the unique facts of the VCN no-action letter. Personnel of a nonprofit entity that operates an investor forum may receive compensation, as long as it is commensurate in form and amount with providing administrative services and does not otherwise suggest broker-dealer or investment adviser activity.²⁹¹

Although financial gain is not altogether prohibited in the SEC’s more recent matching service letters, there is a distinct focus in both the symposium and matching service letters on economic development goals that transcend individual wealth creation. The parties requesting the no-action letters consistently emphasized job creation and similar public benefits.²⁹² In the case of the symposium letter, the SEC specifically cited those benefits in granting no-action relief.²⁹³

Perhaps this emphasis on economic development goals and nonprofit status is another means of ensuring that investors participating in the forum

288. Venture Capital Network, Inc., SEC No-Action Letter, 1984 WL 45334 (May 7, 1984).

289. *Id.*

290. *Id.*

291. Arizona Capital Network, Inc., *supra* note 267 (indicating that employees of a nonprofit organization involved in administering a matching service would be paid commensurate with other employees in a like position); Technology Capital Network, Inc., *supra* note 266.

292. *E.g.*, Arizona Capital Network, Inc., *supra* note 267; Michigan Growth Capital Symposium, *supra* note 268 (“The objective of this activity is to help young and growing businesses, many of which are technology-based, to gain access to appropriate capital markets and to help them expand the job base in a state which is in transition from a heavy reliance on a declining large automotive manufacturing industry and which does not have a well developed venture capital and investment banking infrastructure.”); Texas Capital Network, Inc., *supra* note 267 (“TCN’s objective is to help generate economic growth by matching business ventures in various stages of development (start-up or emerging companies, for the most part) with potential investors.”).

293. Michigan Growth Capital Symposium, *supra* note 268.

are not confused about the role of the forum organizer. Operation by an educational institution, governmental body, or nonprofit organization may reduce the chances that investors will incorrectly assume that a securities professional is looking out for their interests. There may be greater chance for confusion, however, when the matching service is operated to generate profits in a manner similar to the prequalification sites operated by registered broker-dealers. This may be another example of the importance not only of investors being capable of fending for themselves but also of their knowingly taking responsibility for doing so.

D. *Application to Angel Groups*

This section applies the principles described above to current forms of angel groups and argues that angel groups, even those with active managers receiving substantial compensation, do not necessarily violate the ban on general solicitation or require registration as intermediaries. Other commentators have noted potential legal risks associated with angel groups, but at a general level without discussion of the full range of angel group forms.²⁹⁴ This section tries to provide a more complete picture of the regulatory landscape for angel groups by identifying which specific forms operate in the areas of greatest uncertainty.

1. Similarities to Investor Forums

With respect to portions of the investor forum letters relating most directly to general solicitation concerns, most angel groups operate similarly to a matching service or investment symposium.

For example, it is standard practice for angel groups to limit participation to accredited investors. This practice recognizes that the company will likely rely on Rule 506 in selling the securities and will want to limit sales to accredited investors in order to avoid burdensome disclosure requirements.²⁹⁵

Angel groups also advertise and promote themselves in ways that are consistent with the investor forum letters. Most angel groups are not hard

294. Ibrahim, *supra* note 4. Michael Raymond states that investor forum no-action letters are available to nonprofit organizations only, without addressing what this means for actively managed angel groups. Raymond, *supra* note 19, at 12. Darian Ibrahim also does not discuss actively managed angel groups. He does analyze whether an investor is a broker-dealer by receiving stock as a reward for leading due diligence during the group's selection process. Ibrahim, *supra* note 4, at 759. Ibrahim proposes a new exemption for this practice. *Id.* at 761. The risk to an investor, however, should be low if it is an isolated occurrence. *See supra* note 181.

295. PRESTON, *supra* note 55, at 6.

to find through a website,²⁹⁶ and the group may welcome publicity through local media and community organizations. But as long as any advertisements or public statements promote the group as a whole, and not investment in an individual portfolio company, it is hard to distinguish these publicity efforts from the “small classified ads” permitted in the Texas Capital no-action letter or the *Venture Journal* advertisement permitted by the symposium letter, notwithstanding the SEC’s unarticulated concern over “unrestricted” advertising.²⁹⁷

In fact, localized angel groups should raise less concern regarding general solicitation than a computer matching service. To the extent the number of offerees matters, an angel group has a discrete size (typically from 20 to 125 members).²⁹⁸ Some angel groups are very selective about membership, including requiring a recommendation of an existing member or specific expertise.²⁹⁹ In contrast, the matching service letters do not reference any numerical limitation on the number of participants or qualifications other than accredited investor status.

2. Economic Development Benefits

If it is also necessary to identify economic development benefits from angel groups in order to draw upon the investor forum no-action letters, there is plenty of grist for the mill. Policymakers laud angel groups as a way to close the funding gap. For example, in congressional hearings on the termination of the SBA’s Participating Securities program, angel groups were specifically identified as an important alternative source of funding.³⁰⁰ The fact that angel groups are viewed as a replacement for a public program suggests a public benefit beyond personal wealth creation. The potential public benefit of angel groups is also evidenced by nonprofit organizations that have been established to study and foster their

296. Ibrahim, *supra* note 4, at 743 (“[W]hile informal angels prefer anonymity, angel groups are exactly the opposite. Most of them have their own websites, like VCs, and are also easily found through a few clicks on the ACA’s website.”).

297. See *supra* text accompanying notes 274-278.

298. PRESTON, *supra* note 55, at 31 (citing CVR study results indicating that informal angel groups typically have no more than 20 members, nonprofit groups typically have from 25 to 125 members, and LLCs (typically funds) often limit membership to 50 to 75 investors).

299. *Id.* (indicating that “[m]ost groups appear to require a current member’s recommendation or sponsorship for a new, potential member”); Ibrahim, *supra* note 4, at 744 (“[A] small number of angel groups limit membership to those angels with expertise in a particular industry Some angel groups that do not limit membership by industry do limit membership to angels with technical experience and thereby exclude lawyers, accountants, and other ‘non-techies.’”).

300. Participating Securities Hearings, *supra* note 6, at 8, 9, 52-63.

development.³⁰¹

Claims of economic development benefits are particularly strong in regions where significant VC funding is not available. Angel groups have been identified as a way to foster an entrepreneurial economy outside of VC hot spots.³⁰²

3. The Harder Question: Intermediary Status of Actively Managed Groups

Whether an angel group complies with portions of the investor forum letters relating most directly to intermediary status, however, greatly depends on the specific structure of the group. Intermediary status should be of minimal concern to volunteer-based groups that rely on investor volunteers or that use a modest administrative staff compensated from proceeds of member dues, presenting company fees, and sponsorships. Such an administrative staff is unlikely to have a significant role in advising on the merits of transactions or negotiating investment terms, and their compensation is not transaction-based.³⁰³

The manager of an actively managed group, however, may not fit within the letter of the investor forum letters insofar as those letters contemplate a limited role for the forum operator. An active group manager may provide services that, at first glance, look like advising on the merits of investments. For example, the manager may prescreen entrepreneur submissions to identify strong candidates³⁰⁴ and may participate in negotiations with the portfolio company.³⁰⁵ Moreover, active managers may receive fees similar to those received by VC managers, including a management fee equal to a percentage of committed funds and a carried interest, rather than the administrative fees received by the operators of the investor forums.³⁰⁶

301. *See id.* at 60 (discussing the Angel Capital Foundation, a 501(c)(3) organization that studies angel investing and angel groups).

302. Ibrahim, *supra* note 4, at 745-53 (arguing that angel groups have distinct advantages over VC funds and state-sponsored funding in non-tech regions).

303. *See* PRESTON, *supra* note 55, at 38 (discussing sources of revenues to cover administrative support for volunteer-based groups).

304. *See supra* text accompanying note 64.

305. *Id.*

306. *See* PRESTON, *supra* note 55, at 24 (citing Washington Dinner Club as an example of an actively managed group that compensates its manager through a management fee and 15% carried interest); *id.* at 39 (indicating that a management fee equal to 2-3% of committed capital and carried interest is typical compensation for an actively managed group).

4. Availability of VC Exemptions

If an actively managed angel group has a difficult time complying with the investor forum letters because of features that resemble VC funds, it is worth considering whether VC exemptions from intermediary regulations are available to angel group managers. If so, any departure from the investor forum letters may not matter. As discussed below, however, VC exemptions are only a partial solution to the regulatory concerns of angel groups.

Like VC managers, active angel group managers are likely not broker-dealers because their ongoing management role with the group³⁰⁷ and their status as manager of the LLC formed for the investment³⁰⁸ qualifies them for the issuer exemption.³⁰⁹

When it comes to potential investment adviser regulation, however, the analysis is less straightforward. For example, structuring an angel group as an LLC may allow an active manager to claim the benefit of the private adviser exemption for advisers to fewer than 15 funds, just like a VC manager, because the LLC is a single client.³¹⁰ In the future, an angel group manager may be able to take advantage of the exemption for VC funds³¹¹ or for advisers to private funds³¹² to be established under the Dodd-Frank Act. The benefit of these exemptions is limited, however, by the fact that an adviser with less than the threshold amount under management for federal registration will be subject to registration in its home state,³¹³ which may or may not provide an applicable exemption for advisers to a small number of clients.³¹⁴

In the absence of the private adviser exemption, an active angel group

307. *See id.* at 44 (“Managers are valuable for follow-on communications and updates, as can be executive directors”).

308. *See id.* at 27 (“LLCs work well for manager-led funds, even with group members desiring active involvement in group management or governance, since the manager can be designated as the managing member or given other designated authority . . .”).

309. *See supra* text accompanying note 237 (discussing applicability of the issuer’s exception to VC managers).

310. *See supra* text accompanying notes 245-247 (discussing the private adviser exception).

311. Dodd-Frank Act § 407.

312. *Id.* § 408. This exemption will apply to advisers of funds that would be investment companies but for Sections 3(c)(1) or 3(c)(7) of the Investment Company Act, provided the adviser has less than \$150 million under management.

313. 15 U.S.C. § 80b-3a (2006).

314. LEMKE & LINS, *supra* note 206, at 22 (“Many states also have exemptions from registration for advisers with a limited number of clients or only certain institutional clients (e.g., banks, insurance companies, etc.). However, it should be noted that these state exemptions may be more strict in some respects than the Advisers Act (e.g., limiting an adviser to only five clients).”).

manager may, like a VC manager, take the position that it simply does not constitute an investment adviser as defined in the Adviser Act and comparable state definitions³¹⁵ because its activities are sufficiently distinct from those of the defendants in the *Abrahamson* case.³¹⁶ But an angel group manager cannot rely on the same arguments advanced by VC managers. VC managers cite their total control of the pooled funds as a reason for why their activities are qualitatively different from those of a traditional investment adviser, even one with discretionary authority over an account.³¹⁷ An angel group manager, on the other hand, does not have that degree of control because investment decisions are made through an investor-led process such as a majority vote of investors. An angel group manager might, therefore, cite its *limited* control and the investors' primary responsibility for investment decisions as the basis for a non-adviser approach.

For an angel group manager to make a compelling non-adviser argument, it must articulate what role it plays if not providing investment advice. In this regard, analogies can be drawn to the no-action letters discussed above relating to investment software tools and educational programming. The software no-action letters can be read as distinguishing between rendering investment advice to passive investors and providing content-neutral tools based on generally available information.³¹⁸ Like those software tools, an angel group manager designs a process that enables members of the group to evaluate investment opportunities for themselves, but it is only a tool and does not purport to make ultimate recommendations to investors. Similarly, the Missouri Innovation Center no-action letter discussed above can be read as distinguishing between rendering investment advice and providing education to individuals who want to learn how to invest for themselves.³¹⁹ This distinction between education and advice is helpful because members of angel groups often cite education as a primary reason for their participation.³²⁰

5. The Hardest Issue: Transaction-Based Compensation

Regardless of whether an angel group manager tries to address

315. *See supra* note 209.

316. *See supra* text accompanying notes 240-244.

317. *Id.*

318. *See supra* text accompanying notes 212-213 (discussing EJV Partners, L.P., SEC No-Action Letter, 1992 WL 372147 (Dec. 7, 1992), and other no-action letters regarding computer and data services).

319. *See supra* text accompanying note 214 (discussing Missouri Innovation Center, Inc., SEC No-Action Letter, 1995 WL 643949 (Oct. 17, 1995)).

320. *See supra* note 58.

intermediary status by complying with the specific contours of the investor forum letters³²¹ or takes a non-adviser approach like some VC managers, the form of compensation to the angel group manager will be important to the analysis. If an angel group manager receives a management fee and a carried interest (rather than the administrative fees referenced in the investor forum letters) is that indicative of broker-dealer or investment adviser activity?

The analysis should turn on two questions: (1) whether the form of compensation reveals that the true nature of the service is dispensing investment advice (for investment adviser status) or effecting securities transactions (for broker-dealer status) and (2) whether it poses any special risk to investors.³²²

As discussed above, a management fee based on a percentage of committed funds is sufficiently distinct from a sales commission that it should not indicate broker-dealer status under the two-part test.³²³

A carried interest might initially appear suggestive of broker-dealer status because it is to some extent dependent on completion of securities transactions—each completed investment is an opportunity for a fee. But examined closely under the two-part test, a carried interest does not indicate broker-dealer activity.

First, a carried interest does not strongly suggest that the true nature of the services is effecting transactions in securities because the amount of compensation ultimately earned depends on the long-term outcome of the investments rather than the completion or frequency of transactions. It therefore appears that the intermediary is being compensated either for services that affect the quality of investments as they are initially made (for example, investment advice)³²⁴ or for activities that enhance the value of the securities after they are purchased. A commission, in contrast, is earned as soon as transactions are completed regardless of the long-term results. From this perspective, a carried interest is significantly less indicative of broker-dealer activity than is a traditional commission.

Second, a carried interest does not create the same risks to investors as

321. For example, an angel group would demonstrate fidelity to the investor forum letters by: designating a committee of investors (rather than the manager) to screen applicants, perform due diligence, and negotiate transactions; formulating standard investment terms to reduce the role of the manager in negotiations; reducing the carried interest from the VC standard of 20% to 10% to demonstrate a reduced role of the manager; and pursuing partnerships with nonprofits to underscore the public benefits of the group.

322. See *supra* text accompanying notes 219-229.

323. See *supra* text accompanying notes 188-232.

324. Broker-dealers may provide purchase or sell recommendations to clients, but that function is incidental to their primary function of locating buyers and sellers and handling the mechanics of completing transactions. See *Pruit & Hart, supra* note 177, at 30-65 (discussing Section 202(a)(ii)(c) of the Investment Adviser Act).

traditional transaction-based compensation. Because the intermediary is compensated only if the investment is a good one, the incentives of the investor and the intermediary are far more aligned than would be the case with a commission that is fixed as of the purchase date.

Whether a carried interest and management fee indicates investment adviser status under the two-part test is less clear.

A management fee does not reveal much about the nature of the services performed by an angel group manager. For example, more committed funds will likely result in additional monitoring, tax reporting, and investor communication responsibilities. These responsibilities all arise after investment decisions have been made and after any investment advice may be rendered. Additional committed funds also may indicate that there are more investors to coordinate and more risk if the manager fails to discharge her duties as manager. It is therefore plausible that management fees compensate the manager for something other than investment advice.

Nor does receipt of a management fee pose any particular risk to the members of the group. In fact, a management fee based on funds under management is a preferred form of compensation under the Adviser Act.³²⁵

Whether a carried interest indicates investment adviser status is the most difficult question. A carried interest bases compensation on the success of investments and would be a logical way to compensate someone for giving investment advice. But there are many other responsibilities of an angel group manager that affect investment outcomes and for which a carried interest would be appropriate compensation. For example, investment outcomes are affected by the quality of the evaluation process designed by the manager, the number of companies the manager can attract to apply to the group, and the manager's post-investment monitoring of and managerial assistance to portfolio companies.³²⁶

As to investor risk, a carried interest is a performance fee and therefore might be cause for concern.³²⁷ But the factors that make a performance fee acceptable in the context of a VC fund (or business development company) under applicable exemptions are also present in the context of an angel group.³²⁸ Illiquid investments limit the manager's ability to manipulate timing of investment decisions, and substantial

325. See LEMKE & LINS, *supra* note 206, at 154 (describing a fee based on assets under management as a "typical advisory fee").

326. See Wiltbank, *At the Individual Level*, *supra* note 11, at 6, 10 (discussing how post-investment monitoring improves angel investing outcomes).

327. See *supra* text accompanying notes 221-223.

328. See *supra* text accompanying notes 226-227 (discussing exceptions to the prohibition on performance fees, including for business development companies and qualified purchasers).

ongoing obligations of the manager are an opportunity cost that causes the manager to internalize the cost of failed investments. Finally, the standard practice of requiring group members to be accredited ensures a certain level of sophistication in evaluating the fee structure. On balance, even a carried interest is not particularly indicative of investment adviser status.

6. Are the Investor Forum Letters Even Necessary?

Based on the discussion above, it appears that an actively managed angel group can address intermediary status questions in one of two ways: (1) try to structure the group in a way that permits the strongest possible analogy to the investor forums or (2) argue on general principles (like some VC funds do) that the group manager simply plays a different role than providing investment advice or effecting securities transactions. Arguments based on general principles may be sufficient for angel groups that are selective in accepting new members, just as they apparently are for many VC managers. Those angel groups that broadly solicit members, however, may be in a different situation. The difficulty arises because an angel group that broadly solicits members is doing something qualitatively different from a VC fund—it is potentially engaging in a general solicitation of investors to participate in the group.

To explain further, a VC fund and an angel group structured as an LLC are each involved in two forms of securities transactions: an “upstream” investment in portfolio companies and a “downstream” sale of interests in the VC fund or angel group LLC to participating investors. The manner in which VC funds and angel groups solicit submissions by entrepreneurs for upstream investments in portfolio companies is similar and unproblematic. Although rarely analyzed, it appears acceptable for a VC fund to publicly request submissions by entrepreneurs.³²⁹

When it comes to the “downstream” solicitation of investors in the fund or angel group LLC, however, VC funds and angel groups may operate differently. VC managers are required to make downstream sales to fund investors in compliance with generally applicable requirements of private offering exemptions, including the ban on general solicitation. Therefore, a VC fund manager would not engage in broad solicitations or open advertisements for new investors. In contrast, an angel group that is not selective in admitting new members (requiring accredited investor status only) without adhering to the investor forum no-action letters risks violating the ban on general solicitation with respect to the downstream sale of LLC interests to group members. It is advantageous, therefore, for

329. *See supra* note 158.

the manager of an angel group to operate substantially in conformance with the investor forum no-action letters³³⁰ because they provide a framework for addressing the twin concerns of general solicitation and intermediary status.

Neither of the options currently available to angel group managers provides adequate certainty. For example, the VC industry felt it necessary to obtain special statutory exemptions because the SEC is reluctant to embrace the non-adviser approach.³³¹ An angel group manager likely faces a similar level of uncertainty in arguing that it does not provide investment advice. Trying to comply with the investor forum letters is also problematic in light of any no-action letter's limited precedential value³³² and the SEC's failure to articulate its underlying reasoning in granting no-action relief. Either approach requires relying on untested arguments regarding whether a carried interest indicates investment adviser or broker-dealer activity. For an increasingly common and favored form of investing,³³³ angel groups should have regulatory clarity, not just good arguments.

VI. REFORM PROPOSAL

This part outlines a new approach to regulating startup company finance that reflects current best understandings of angel investing. The goal is to focus squarely on whether investors require the protection of registration rather than on ancillary concepts like general solicitation or transaction-based compensation which are difficult to apply or impractical in the context of startup company finance. The hope is that a more focused approach enhances the ability of entrepreneurs and intermediaries to comply and will be more accommodating to new developments that are helpful to investors.

This article proposes a new exemption under Regulation D with the following features:

The new exemption would be available only to privately held operating companies. It would not be available to entities primarily holding or developing real estate, investment funds (other than those investing in startup companies), or publicly traded companies.

The exemption would apply if all sales are made to accredited

330. *See supra* note 321.

331. *See supra* note 244.

332. *See supra* note 21.

333. *See supra* note 300.

investors, with the added requirements below.

To qualify as accredited under the new exemption, an investor would need to meet the current income or net-worth standard and one of the following:

The investor owns or manages investments³³⁴ in excess of \$1.5 million;

The investor has served as a director or executive officer of a company that, during the investor's service, sold at least \$1 million of securities in Regulation D offerings; or

The proposed investment does not exceed 10% of the investor's net worth.

The ban on general solicitation and advertising would be eliminated if the above requirements are met.

Registration as a broker-dealer or investment adviser would not be required because of involvement in transactions under the new exemption.

The proposed exemption could preempt state requirements to register sales of securities that qualify under the exemption,³³⁵ but applicable federal statutes would not provide for preemption of state investment adviser or broker-dealer registration requirements. Preempting those intermediary regulations would likely require an act of Congress. The extent to which federal securities laws should preempt state private offering regulations is controversial.³³⁶ The exemption proposed by this article would improve federal law regardless of preemption, and states could independently adopt similar reforms tailored to their current requirements.

A. *Context-Specific*

Efforts to reform private offering regulation are inhibited by the vast range of economic activity regulated by the SEC. This broad charge starts with the Securities Act's definition of a security,³³⁷ which covers not only

334. For this purpose, "investments" could be defined similarly to the way the term is defined for purposes of determining "qualified purchaser" status under the Investment Company Act. That definition generally includes securities, real estate, commodities, and cash and cash equivalents to the extent held for investment purposes. See 17 C.F.R. § 270.2a51-1 (2010) (defining investments for the purposes of determining qualified purchasers).

335. See 15 U.S.C. § 77r(b)(4)(D) (2006).

336. See Alan M. Parness, *From the Chair—Random Rants and Raves*, THE BLUE SKY BUGLE (A.B.A., Chi., Ill.), Apr. 2009, at 3-5 (arguing against proposals to limit the presumptive effects of Rule 506).

337. 15 U.S.C. § 77b (2006).

startup company stock but also securities of Fortune 500 companies offered to institutional investors,³³⁸ interests in real estate,³³⁹ and a broad catchall category of “investment contracts” encompassing a wide range of economic arrangements.³⁴⁰

When regulating a wide variety of conduct, it may be advisable for regulators to have discretion in interpreting the scope of registration requirements, like the general solicitation framework. But within a specific context where investors demonstrate an ability to fend for themselves and more prescriptive regulations become counterproductive, regulations can be more permissive.

The proposed exemption relaxes some elements of current regulations because it mirrors circumstances in which angel investors have demonstrated success. For example, the modified criteria for accredited investor status generally reflect the angel investor profile that has emerged in recent studies.³⁴¹ The first additional requirement (ownership of \$1.5 million in investments) roughly corresponds to the average angel investment portfolio under the Wiltbank study.³⁴² But studies of angel investing suggest that entrepreneurial experience is as important as financial sophistication or resources.³⁴³ Therefore, an investor may also qualify by experience at a company that has been through the fundraising process. Finally, an investor can qualify because the proposed investment does not threaten a large portion (more than 10%) of the investor’s financial resources.³⁴⁴ This allows those with no demonstrated financial or entrepreneurial experience to dip their toes in the pool through a local angel group with the opportunity to learn from more experienced investors.³⁴⁵

The proposed rule also responds to the specific needs of startup companies by relaxing intermediary registration requirements. Because an adequate market for traditional intermediaries has not emerged for startup companies,³⁴⁶ intermediary registration requirements have become

338. LOUIS LOSS & JOEL SELIGMEN, *FUNDAMENTALS OF SECURITIES REGULATION* 246-264 (5th ed. 2004) (“The catalogue of these schemes is as variegated as the imaginations of promoters.”).

339. See generally Alvin Robert Thorup, *TIC or Treat: How Tenant-in-Common Real Estate Sales Can Avoid the Reach of the Securities Laws*, 34 *REAL ESTATE L.J.* 422 (2006) (discussing when certain interests in real estate are securities).

340. LOSS & SELIGMEN, *supra* note 338, at 401.

341. See *supra* text accompanying notes 50-51.

342. Wiltbank, *At the Individual Level*, *supra* note 11, at 3 (finding that respondents held an average of \$1.3 million in angel investments).

343. *Id.*

344. See WASH. ADMIN. CODE 460-44A-504(3)(d)(i) (using this standard as a proxy for suitability).

345. See *supra* text accompanying note 51.

346. See sources cited *supra* notes 169 and 202.

counterproductive in protecting investors. Relaxing registration requirements may provide enough flexibility for new forms of intermediaries to emerge.

B. Objective Application

The most common criticism of current regulations is that Section 4(2) and Regulation D are difficult for issuers to apply. Judicial interpretations by lower courts following *Ralston Purina* applied a number of factors in sometimes inconsistent ways when considering whether a particular offering qualified as private. The state of the case law led the author of one article to warn: “An accurate, succinct statement of the whole body of law under Section 4(2) is beyond the scope of this Article, if not indeed beyond the power of humanity.”³⁴⁷ The SEC’s attempt to clarify matters through Regulation D has not eliminated uncertainty due largely to the ban on general solicitation and its fact-specific focus on preexisting relationships.

A legal rule should be easy to follow in order to take advantage of the teaching, or “pedagogical,” function the law can serve. As Patrick Daugherty wrote 20 years ago:

[I]t often was said (years ago) that pointing out the borders of lawful conduct will only furnish the Holmesian “bad man” with a “roadmap to fraud.” As applied to securities offerings, this philosophy is self-defeating. Since general solicitation is neither *malum in se* nor otherwise self-evident, it must be *made* comprehensible if compliance is to be expected The Staff disserves the pedagogical function of the law when it declines to give a straight answer to a straight rule 502(c) question, asserting instead that the “facts and circumstances” are critical and accessible only to the issuer’s lawyer.³⁴⁸

That the law of private placements can positively influence investing behavior, rather than simply punish wrongdoing, is observable in the operation of angel groups. Disclaimers on websites operated by volunteer-based groups emphasize specific factors cited in the investor forum letters, including that the group operators do not provide investment advice, negotiate terms, receive transaction-based compensation, or hold themselves out as a securities professional.³⁴⁹ If there were similar

347. Daugherty, *supra* note 150, at 76-77.

348. *Id.* at 124.

349. *E.g.*, *Legal Disclaimer*, ALLIANCE OF ANGELS, <http://www.allianceofangels.com/legal.aspx> (last visited Oct. 30, 2010). *See also* PRESTON, *supra* note 55, at app. 2 (providing a sample form of membership agreement for a member-led group that includes similar disclaimer language).

guidance for actively managed angel groups, they too could be expected to follow it.

The proposed exemption would provide more meaningful guidance to issuers than current law. Startup companies are accustomed to making determinations of accredited investor status under the existing standards and could do the same under the proposed exemption.

VII. CONCLUSION

Actively managed angel groups are breaking new ground by combining elements of informal angel networks with elements of VC investing. As a result, they may not fit neatly into either the investor forum letters or VC fund exemptions from intermediary regulation. But that does not mean they run afoul of intermediary registration requirements or the ban on general solicitation. Examined closely, these groups are a collaborative effort by capable investors to actively invest their own funds more effectively than they could individually. Thus, the underlying logic of the investor forum letters applies, even if the manager's form of compensation and duties diverge from some of the facts cited in the letters.

Ideally, it would not take fifty law review pages to find a foothold in the regulatory framework for a form of investor self-help like angel groups. Properly oriented regulations would not get so bogged down in ancillary questions of transaction-based compensation and pre-existing relationships. The reform proposed by this article would put the best current information about angel investing to use with the idea of reorienting the regulatory framework to focus on demonstrated conditions for successful investment in a market that policy makers are desperately seeking to encourage. Hopefully, the SEC can keep this context-specific approach in mind as it fulfills its current mandate under the Dodd-Frank Act to review fundamental aspects of its private offering regulations.