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SEC Proposes Exemptions for Advisers to Venture Capital Funds

Advisers that fit a narrow definition of "venture capital fund" would be exempt from registration requirements imposed by the Dodd-Frank Act.

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Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), referred to as the Private Fund Investment Advisers Registration Act of 2010, effected fundamental changes in the Investment Advisers Act of 1940 (Advisers Act) that will result in many previously unregistered advisers, such as advisers to private funds, having to register with the U.S. Securities and Exchange Commission (SEC) or one or more state regulators, absent an exemption from registration. When the Dodd-Frank Act was signed into law on July 21, 2010, most of its impact had not yet been determined, as the implementation was left in the hands of industry regulators.

Now the SEC has spoken. At an open meeting on November 19, 2010, the SEC voted to propose rules that would implement a registration exemption and reporting requirements for advisers to venture capital funds, as required by the Dodd-Frank Act. In the proposing release, the SEC sets forth proposals to adopt registration exemptions for venture capital fund advisers (Exemptions Release).[1] Comments on the proposal must be submitted to the SEC by January 24 and may be submitted online at the SEC's website.

Exemption for Venture Capital Fund Advisers

The Dodd-Frank Act amended Section 203(l) of the Advisers Act to provide an exemption from SEC registration requirements for any investment adviser that acts as an investment adviser solely to one or more venture capital funds. There is no limit on the number of venture capital funds a venture capital fund adviser may advise and still qualify for the exemption. In general, venture capital funds, according to the SEC, are a subset of private equity funds and are typically unleveraged long-term investors in early-stage or small privately held companies, thereby limiting their ability to contribute to systemic risk.

The Dodd-Frank Act also directed the SEC to issue final rules to define the term "venture capital fund" for the purposes of the exemption by July 21, 2011, and further directed the SEC to require venture

1. *See* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Advisers Act Rel. No. 3111 (Nov. 19, 2010), *available at* http://www.sec.gov/rules/proposed/2010/ia-3111.pdf.

capital fund advisers to maintain records and provide the SEC with annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors.

In the Exemptions Release, the SEC sets forth Proposed Rule 203(l)-1 under the Advisers Act, which would define the term "venture capital fund," sets forth a grandfathering provision for existing venture capital funds, and defines additional terms used in the definition of "venture capital fund."

Proposed Definition

Under Proposed Rule 203(l)-1(a) (Proposed Rule), a fund would have to meet *all* of the following criteria in order to be considered a "venture capital fund."

1. ***The fund must be a private fund.***

In order to meet the definition of "venture capital fund" set forth in the Proposed Rule, the fund must be a "private fund," as defined in Section 202(a)(29) of the Advisers Act, as revised by the Dodd-Frank Act. Under Section 202(a)(29), a "private fund" is an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940 (1940 Act), but for the exemptions from the definition of "investment company" set forth in Section 3(c)(1) or 3(c)(7) of the 1940 Act.[2] The fund cannot be an investment company registered under Section 8 of the 1940 Act or elect to be treated as a business development company under Section 54 of the 1940 Act.

2. ***The fund must represent to investors and potential investors that it is a venture capital fund.***

In order to meet the definition of "venture capital fund," a fund must represent itself to the investing public as a venture capital fund. In the Exemptions Release, the SEC indicated that a fund that describes its investment strategy as "venture capital investing" or "investing in compliance with Rule 203(l)-1" would be deemed to be representing itself to investors and potential investors as a venture capital fund. The SEC further stated that a fund could not identify itself as a hedge fund or a multistrategy fund (i.e., a fund where venture capital is one of several investment strategies) and still fulfill this requirement. Further, the fund's adviser would not be able to include the fund in a hedge fund database or index of hedge funds.

3. ***The fund must own solely (i) equity securities issued by one or more "qualifying portfolio companies" (QPCs), at least 80% of which were acquired directly from the QPCs; and (ii) cash, cash equivalents, or U.S. Treasury instruments with a remaining maturity of 60 days or less.***

In order to be defined as a "venture capital fund," a fund can only own equity securities of QPCs and cash, cash equivalents, or U.S. Treasury instruments with a remaining maturity of 60 days or less.

A fund cannot invest in debt instruments of a QPC unless such instruments can be considered "equity securities" under Section 3(a)(11) of the Securities Exchange Act of 1934 (1934 Act) and Rule 3a11-1 thereunder.[3] Eligible securities offered by a QPC in which a fund may invest are common or preferred

2. In general, the exemptions provided in Sections 3(c)(1) and 3(c)(7) of the 1940 Act apply to private funds with fewer than 100 investors or investors who are qualified purchasers.

3. Under Section 3(a)(11) of the 1934 Act, "equity security" is defined as "any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the

stock, warrants, convertible securities, or interests in a limited partnership. Further, the SEC noted that a fund could provide a QPC with "bridge financing" in anticipation of future investment in exchange for instruments that are ultimately convertible into stock of the QPC. Any bridge financing by a fund to a QPC in exchange for an instrument that is not an "equity security" would disqualify the fund from the definition of "venture capital fund" and thereby disqualify the fund's adviser from the exemption from registration. A fund may also invest in cash and cash equivalents, as defined in Rule 2a51-1(b)(7)(i) under the 1940 Act.[4]

Under Proposed Rule 203(l)-1(c)(4), a company would have to meet *all* of the following criteria in order to be considered a QPC.

a. *At the time of any investment by the fund, the company was not publicly traded and did not control, was not controlled by, and was not under common control with another company, directly or indirectly, that is publicly traded.*

A fund may continue to hold securities of a company that goes public after the fund's investment, but the fund cannot make additional investments in the company after it goes public and still qualify as a "venture capital fund." In the Exemptions Release, the SEC acknowledged that a fund's portfolio could consist entirely of publicly traded securities and the fund could still qualify as a "venture capital fund" under the Proposed Rule so long as the fund acquired all of the securities prior to their being publicly traded. The SEC noted that although venture capital funds typically invest in small, startup companies, these concepts were not built into the proposed definition of "venture capital fund" because the SEC was concerned that too many companies would be eliminated from possible investment by venture capital funds as a result. The SEC also did not include any length-of-existence, number-of-employees, or revenue thresholds under the definition of QPC. Finally, the SEC considered, but did not adopt, the definitions of "venture capital fund" used by the California Corporations Commission and U.S. Department of Labor, both of which permit a fund to invest in publicly traded companies and permit a fund to invest up to 50% of its assets in nonoperating companies (i.e., investment funds). In rejecting this approach, the SEC referenced Congress's concern that fund-of-funds structures present systemic risk concerns.

b. *The company does not borrow or issue debt obligations, directly or indirectly, in connection with the fund's investment.*

A company will not meet the definition of a QPC if it borrows money, issues debt, or otherwise incurs leverage in connection with the fund's investment. A company may, however, borrow money as part of its normal course of business (i.e., to invest in infrastructure or make payroll) and still qualify as a QPC. This "in connection with the fund's investment" requirement is aimed at preventing advisers to leveraged-buyout funds from relying on the venture capital fund advisers exemption since, according to the SEC, leveraged-buyout funds present a greater systemic risk than venture capital funds. The SEC noted that any financing or loan to a company that is provided by a fund that invests in the company or is a condition of a contractual obligation with the fund (or adviser) would be viewed as a loan in

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Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security."

4. "Cash and cash equivalents" are defined under Rule 2a51-1(b)(7)(i) as "[b]ank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes." The SEC noted that cash and cash equivalents must be held for "investment purposes" as required by Rule 2a51-1(b)(7)(i), and that a fund may also invest in short-term obligations of the U.S. Treasury that mature in 60 days or less, which are not included in the definition of "cash and cash equivalents" under Rule 2a51-1(b)(7)(i).

connection with the fund's investment and would thus disqualify the company from the definition of a QPC and the fund from the definition of a venture capital fund.

c. The company does not redeem, exchange, or repurchase any of its securities, or distribute to pre-existing security holders cash or other assets, directly or indirectly, in connection with the fund's investment.

In order to qualify as a QPC, a company must use the fund's investment for operating and business purposes and for facilitating the expansion and development of the company. The definition of "venture capital fund" requires that at least 80% of a QPC's securities held by the fund must have been acquired directly from the QPC and not from existing shareholders, either directly or indirectly. This 80% test is aimed at preserving the existing rights, priority, and economic terms of the QPC's beneficial owners while still permitting the QPC to benefit from the fund's investment. The 80% test would prohibit a company from using the capital inflow from the fund's investment to buy out all existing shareholders or reconstitute its capital structure to subordinate the rights of its existing shareholders. The SEC noted that the Proposed Rule would permit a fund to acquire up to 20% of the securities of a QPC from shareholders, which would allow a QPC to use a fund's investment to redeem a certain number of its outstanding securities, thus providing some liquidity to its angel investor(s), if any. Further, the SEC stated that the 80% test is not intended to preclude capital reorganizations by a company that would not change the rights, priority, or economic terms of existing beneficial owners. The SEC also noted that the 80% threshold is consistent with certain tax treatment typically relied on by venture capital funds.[5]

d. The company is not an investment company, a private fund, an issuer that would be an investment company but for the exemption provided by Rule 3a-7 under the 1940 Act, or a commodity pool.

In order to meet the definitional requirements of a QPC, a company cannot be a private fund or other pooled investment vehicle, including an investment company, an investment company relying on Rule 3a-7 under the 1940 Act, or a commodity pool. The SEC noted that Congress provided no indication that the venture capital fund exemption was meant to apply to funds-of-funds. There is no requirement that the QPC be a U.S. company.

4. ***The fund must, with respect to each QPC (either directly or indirectly through its adviser), either (i) have an arrangement whereby the fund or the adviser offers to provide, and if accepted, does so provide, significant guidance and counsel concerning the management, operations, or business objectives and policies of the QPC; or (ii) control the QPC.***

For each QPC in which the fund invests, the fund (or its adviser) must either control the QPC or offer to provide significant guidance and counsel to the QPC regarding its management, operations, or business objectives and policies.[6] If the QPC accepts the fund's (or adviser's) offer to provide such guidance and

5. In general, Section 1202 of the Internal Revenue Code provides a partial exclusion from a taxpayer's gross income for gain from the sale or exchange of qualified small business stock held for more than five years. In order to be "qualified," the small business must be an "active business." Section 1202(e)(1)(A) of the Internal Revenue Code notes that if at least 80% of a company's assets are used by the company in the active conduct of one or more qualified trades or businesses, then the company meets the "active business" requirement.

6. In the Exemptions Release, the SEC noted that the concept of providing guidance and counsel to the QPC regarding management, operations, or business objectives and policies is intended to be a more streamlined version of the concept of "managerial assistance" defined in Section 2(a)(47) of the 1940 Act, which applies to investment in business development companies. The SEC noted that Congress's discussions of business development companies in the 1980s are instructive to the concepts in the Proposed Rule, though not directly considered by Congress in passing the Dodd-Frank Act.

counsel, the fund (or adviser) must actually provide guidance and counsel to the QPC. The Exemptions Release states that the fund's (or adviser's) guidance and counsel must be more than a mere contribution of capital and instead must entail active involvement in the business, operations, or management of the QPC or less active "control" through board representation or similar voting rights. The SEC also stated that the extent of the fund's (or adviser's) managerial assistance may evolve over time as the QPC expands and develops. On the assumption that if control exists it will likely be exercised, the Proposed Rule does not require a fund (or adviser) that controls a QPC to offer to provide managerial assistance. The Proposed Rule, however, does not provide any direct guidance on the meaning of "control." Additionally, if the fund invests as a group of funds, each fund (or its adviser) would have to either exercise control over the QPC or offer to provide managerial assistance to the QPC and, if accepted, actually provide managerial assistance to the QPC.

5. ***The fund cannot borrow, issue debt obligations, provide guarantees, or otherwise incur leverage in excess of 15% of its aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee, or leverage must be for a nonrenewable term of no longer than 120 calendar days.***

In order to meet the definition of "venture capital fund," a fund cannot borrow, issue debt obligations, provide guarantees, or otherwise incur leverage in excess of 15% of its aggregate capital contributions and uncalled committed capital. If the fund does conduct such leveraging activities, it must be for a nonrenewable term of no longer than 120 calendar days. The SEC noted that a fund may issue short-term debt, such as commercial paper, and still be considered a "venture capital fund." Because the 15% threshold is calculated as 15% of the fund's aggregate capital contributions and uncalled capital commitments, it would be possible for the fund to leverage an acquisition of QPC securities up to 100% so long as the invested amount does not exceed 15% of the fund's total capital commitments. All such leverage would still be limited to 120 days or less. The SEC noted that a fund cannot avoid the prohibition on QPC borrowing by incurring debt at the fund level.

6. ***The fund must only issue securities that do not provide investors with any right (except in extraordinary circumstances) to withdraw, redeem, or require the repurchase of such securities.***

Outside of extraordinary circumstances, a fund cannot require investors to sell securities back to the fund or grant investors the right to redeem or withdraw their securities. Extraordinary circumstances could include changes in the law that would affect investors' tax treatment or ability to invest in particular countries and industries, or foreseeable but unexpected corporate events, such as mergers. If the fund offers quarterly or periodic withdrawal rights, it cannot qualify as a "venture capital fund," even if the fund has a temporary initial lock-up period or other restriction on the right to redeem. The Proposed Rule does not set forth any specific time period for which fund interests must be held, though the SEC noted that industry practice is usually 10 years.

Grandfathering

The Proposed Rule also exempts an adviser to a fund that does not meet the definition of "venture capital fund," but that is a private fund that (1) represented to investors and potential investors at the time it offered its securities that it was a venture capital fund, (2) sold securities to one or more investors prior to December 31, 2010, and (3) does not sell securities (including additional capital commitments) to any person after July 21, 2011. The SEC specified that in order to meet the grandfathered exemption, capital commitments from the fund's investors need not be called by July 21. Further, the SEC noted that it does not expect that advisers to private equity or hedge funds will be able to rely on the grandfathering exemption.

Other Items

The SEC noted that the Proposed Rule does not require an adviser to provide a capital contribution to its fund, does not specify a minimum investment term, and does not exclude funds that permit investment by retail investors. The SEC also stated that an adviser with its principal place of business outside the United States may rely on the exemption if all of its clients—whether U.S. or non-U.S. clients—are venture capital funds.

The exemption provided to advisers to venture capital funds under the Proposed Rule is not mandatory and such advisers may voluntarily register. Unregistered venture capital fund advisers may still be subject to state registration requirements, as Section 203A(b)(1) of the Advisers Act only provides an exemption from state registration requirements to advisers that are registered with the SEC.

PRACTICAL CONSIDERATIONS

The combination of the elimination of the *de minimis* exemption (the 15-client rule), upon which many venture capital fund managers currently rely, and the new explicit carveout from any registration requirements for venture capital fund advisers means that a venture capital fund adviser will no longer be limited to fewer than 15 clients (i.e., 15 venture capital funds). Consequently, venture capital fund advisers that are self-constrained by the 15-client rule so as to avoid registration will no longer be limited by the number of funds they can manage, so long as all of the funds they manage meet the definition of "venture capital fund." Nonetheless, although still not registered, such managers will be subject to the additional reporting requirements detailed in a companion proposing release issued by the SEC on the same day as the Exemptions Release and will continue to be subject to the antifraud provisions of the Advisers Act.

Venture capital fund advisers should consider altering practices and limiting activities so as to conform to the proposed definition of "venture capital fund." For example, advisers may want to make their representations to the public more explicit so as to meet the requirement that they represent themselves as venture capital funds. Advisers will also have to install policies and procedures to determine that the companies they invest in are QPCs and that they acquire at least 80% of the securities they own of each QPC from the QPC itself. Advisers may want to consider building into their purchase agreements for shares that the QPC will use the funds for operating and business purposes and not to buy out shareholders. If an individual QPC does intend to use a portion of its funds to provide liquidity to an angel investor, this should be noted by the adviser and the QPC during the purchase of the QPC's securities. Advisers will also have to ensure that QPCs do not borrow money outside of the normal course of business or issue any debt securities. Advisers should also make a record of their offers to provide managerial assistance and, if applicable, the QPCs' acceptance or rejection of such offers.

Regardless of whether an adviser qualifies for exemption from registration with the SEC, all venture capital fund advisers will be subject to the reporting requirements set forth in the companion proposing release, including proposed revisions to Item 7B and Schedule D of Form ADV that would require advisers to provide identifying information about each of their private funds, such as each fund's name and domicile, ownership, service providers, and assets. Venture capital fund advisers would also be subject to examination by the SEC. In the companion reporting release, the SEC noted that such increased disclosure of private funds would help the SEC target its examinations.

ADDITIONAL INFORMATION

If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact the authors, **Ethan W. Johnson** (305.415.3394; ejohnson@morganlewis.com) and **John J. O'Brien** (215.963.4969; jobrien@morganlewis.com), or any of the following Morgan Lewis attorneys:

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