Many venture capital and private equity fund managers eagerly anticipated the recent SEC rule change initiated by the Investment Company Act of 1940 (the “Advisers Act”) and the Securities Exchange Act of 1934 (the “1934 Act”), respectively, in which the SEC issued the Investment Advisers Act of 1940 (the “Advisers Act”) (amended by the Dodd-Frank Act) change to the definition of “venture capital fund” under the Advisers Act. The change, which was introduced by the Dodd-Frank Act (the “Dodd-Frank Act”), has historically served as the basis for many venture and private equity managers alike to hope that the Rule as finalized by the SEC would afford broader relief than the Rule as proposed (the “Proposed Rule”) by the SEC in November of last year. The Rule clearly offers a greater threat of providing managers an exemption from Advisers Act registration, but that group is still relatively limited. SEC Chairman Mary Schapiro emphasized the narrow nature of the definition of venture capital fund adopted by the SEC during her opening statement at the meeting at which the Rule’s adoption was confirmed.

Our definition distinguishes venture capital funds from hedge fund and private equity funds by focusing on the lack of leverage of venture capital fund and the non-public, start-up nature of the companies in which they invest. The rule therefore focuses on the provision of capital for the development and expansion of start-up businesses, rather than buying out prior investors. In crafting the definition of venture capital fund, our goal was to develop a definition that provided an accurate and legitimate definition of venture capital fund, without including loopholes that could be inappropriately exploited down the road.

As written by the SEC, the definition in general encompasses only funds that engage in traditional venture capital activities and investment strategies. Funds that (1) engage in a broader form of investing (e.g., growth equity investments or control transactions); (2) regularly use leverage in their investments; (3) regularly purchase shares from existing shareholders; and/or (4) regularly invest in public companies will fall outside of the definition, but the result that those managers will be subject to Advisers Act registration unless they can rely on some other exemption or exclusion under the Act.

A description of the background, scope and operation of the Rule as adopted by the SEC follows below.

**Background**

The Dodd-Frank Act rescinds, effective as of July 21, 2011, the “private advisor” exemption under the Investment Company Act of 1940 (the “1940 Act”), as amended by the Dodd-Frank Act. The exemption was of major consequence to such managers, but that group is still relatively limited. The SEC is of the view that the definition of investment adviser from the requirement to register under the Act if, among other things, the entity advised 14 or fewer clients during the preceding 12-month period and did not hold itself out generally to the public as an investment adviser. The private adviser exemption has historically served as the basis for many, if not most, venture capital and private equity fund managers to conduct their businesses without having to comply with the registration and substantive provisions of the Advisers Act. Under a rule adopted by the SEC in June, a venture capital or private equity fund is one that currently relies on the private adviser exemption will be required to register under the Advisers Act no later than March 30, 2012, unless it qualifies for another exemption from registration under the Advisers Act, such as the venture capital exemption, or is otherwise precluded from registering under the Act.

**Operation of the Venture Capital Exemption**

Section 203(l) of the Advisers Act, as amended by the Dodd-Frank Act, provides for an exemption from registration as an investment adviser under the Advisers Act for an investment adviser that advises solely one or more “venture capital funds” as defined by the SEC. Under the Rule, an investment fund will qualify as a “venture capital fund” if it is a “private fund” that (1) holds no more than 20 percent of the fund’s capital commitments in non-qualifying investments (other than certain short-term holdings); (2) does not borrow or otherwise incur leverage in excess of 15 percent of the private fund’s aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no more than 120 calendar days, excluding certain guarantees by the fund of “qualifying portfolio company” obligations; (3) has never been represented to investors and potential investors as a fund that pursues a venture capital strategy; (4) does not provide its investors with redemption or other similar liquidity rights except in extraordinary circumstances; and (5) is not registered under the Investment Company Act of 1940, as amended (the “1940 Act”), and has not elected to be treated as a business development company under the 1940 Act.

A “private fund” for these purposes is defined as an issuer that does not hold itself out generally to the public as an investment company for the exclusion from that definition under Section 3(c)(1) or Section 3(c)(7) of the 1940 Act.

The Rule, “qualifying investments” are generally investments in equity securities of a “qualifying portfolio company” that are acquired by the fund directly from the qualifying portfolio company, or in a control relationship, with the result that their managers have control over the company or, in limited circumstances, in which a venture capital fund typically buys out of prior investors. In addition, the Rule’s definition of a venture capital fund is of major consequence to such managers, as the ability of a manager to rely on the exemption depends on whether the manager can continue to operate its business largely outside of the scope of the Advisers Act.

Venture capital and private equity managers alike were hoping that the Rule as finalized by the SEC would afford broader relief than the Rule as proposed (the “Proposed Rule”) by the SEC in November of last year. The Rule clearly offers a greater threat of providing managers an exemption from Advisers Act registration, but that group is still relatively limited. SEC Chairman Mary Schapiro emphasized the narrow nature of the definition of venture capital fund adopted by the SEC during her opening statement at the meeting at which the Rule’s adoption was confirmed.

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A “private fund” for these purposes is defined as an issuer that does not hold itself out generally to the public as an investment company for the exclusion from that definition under Section 3(c)(1) or Section 3(c)(7) of the 1940 Act.

Under the Rule, managers selected to establish a sufficiently low threshold to preclude advisers to other types of private funds, such as hedge or private equity funds, from relying on the venture capital exemption.

**Equity Securities**

The definition of a venture capital fund contained in the Rule as adopted contemplates funds that are primarily pursuing equity securities. Under the Rule, investments in non-equity securities, including non-convertible bridge loans and other debt investments, are viewed by the SEC as outside the scope of a venture or private equity fund’s investment activity and may be made by a venture capital fund as defined in the Rule only as part of the fund’s 20 percent basket of non-qualifying investments.

**Secondary Market Transactions**

The Rule’s definition of a qualifying investment does not include securities acquired from existing security holders. This aspect of the definition reflects the SEC’s stated preference to allow a venture capital fund generally invests capital directly in portfolio companies for operating and other business purposes and does not buy out existing security holders. Excluding these secondary market trans-
actions from the category of transactions in which a venture capital fund can engage, according to the SEC, is an important means of distinguishing a venture capital fund from other types of private equity funds outside the intended scope of the venture capital exemption. A venture capital fund within the meaning of the Rule can thus acquire equity securities from existing investors, including acquisitions of shares from founders or employees, only to the extent those investments fit in the fund’s 20 percent basket of non-qualifying investments.

**Investments in Public Companies**

Venture capital investments generally consist of investments in equity securities issued by a qualifying portfolio company. Reporting companies (or companies in a control relationship with reporting companies) are excluded from the definition of qualifying portfolio companies. This exclusion reflects the SEC’s understanding that a venture capital fund, unlike other types of private funds, typically does not trade in the public markets (although such a fund under the Rule could post public offerings into the public markets once it has matured). The Rule provides that a private fund seeking to qualify as a venture capital fund needs to fit investments in reporting companies, and therefore any SEC transactions and post-IPO follow-on investments (which may be common for investments in companies in the life sciences industry), within its 20 percent basket of non-qualifying investments.

**Portfolio Company Leverage**

The SEC clearly believes that leverage should generally not be employed by a private fund attempting to qualify as a venture capital fund. The Rule provides that a portfolio company that incurs debt in connection with an investment by a private fund and distributes the proceeds of the borrowing to the fund in exchange for the investment is not a qualifying portfolio company. The investment by a private fund in such a portfolio company is treated as a qualifying investment under the Rule and could only be made by a venture capital fund within the meaning of the Rule to the extent the investment would fit in the fund’s 20 percent basket of non-qualifying investments.

The Rule as adopted is broader than the Proposed Rule, which restricted qualified portfolio companies engaged in “an investment in connection with” an investment from a venture capital fund. In response to commenters suggesting a leverage criterion that would focus on the use of proceeds derived from portfolio company leverage, the SEC added language to the Rule as finalized with the intent of more specifically delineating the type of investments involving a venture capital fund that would result in a company being excluded from the definition of a qualifying portfolio company. In adopting the Rule, however, the SEC emphasized that restrictions on portfolio company leverage are an important way of distinguishing a venture capital fund from a leveraged buyout fund (which, the SEC notes, is more likely to control equity interests in portfolio companies through the buyout of existing security holders, or finances such investments or buyouts by other means). Moreover, the SEC cited the use of buyouts and associated leverage as investment activity characteristic of the types of funds that are intended not to be venture capital funds within the meaning of the Rule.

**Investments in Operating Companies**

The Rule excludes a private fund’s investments in other private funds or other investment vehicles. In defining a qualification of the Rule has been required to offer (or provide) managerial assistance to, or control, each qualifying portfolio company in which the private fund invests. The managerial assistance element was eliminated by the SEC in the Rule as adopted in part in response to comments on the Proposed Rule that such additional control is not a key or distinguishing characteristic of venture capital investment.

**Inclusion of Non-U.S. Private Funds**

As noted above, meeting the definition of a venture capital fund, the Rule as adopted permits a non-U.S. adviser to rely on the Rule to operate as a private fund, or as a non-U.S. manager of or control person of such entity be a private fund. The definition of private fund in referring to Section 3(c)(1) and Section 3(c)(7) of the 1940 Act and each such fund as being formed under U.S. law or making a U.S. offering. In adopting the Rule, the SEC added a note explaining that the definition of private fund contained in the Proposed Rule was expanded to include the deeming of the venture capital exemption to include a fund formed outside the United States the securities of which were not offered, sold or purchased in the United States by U.S. persons in a manner inconsistent with being a private fund.

**Application to Non-U.S. Advisers**

The SEC, in an important enhancement to the Rule as adopted, confirmed that a non-U.S. adviser, as well as a U.S. adviser, may rely on the venture capital exemption. A non-U.S. adviser may rely on the venture capital exemption if it advises only one or more private funds, whether U.S. or non-U.S., that meet the definition of a venture capital fund within the meaning of the Rule. In this regard, the Rule as adopted is broader than the wording included on commenters on the Proposed Rule requested. These commenters sought an interpretation of the Rule so that a non-U.S. adviser could exclude its non-U.S. activities when evaluating eligibility for the venture capital exemption. Citing the express text of Section 203(l) of the Advisers Act, as amended by the Dodd-Frank Act, the SEC noted that it would not be appropriate to allow a non-U.S. adviser to disregard its non-U.S. activities when assessing eligibility for the venture capital exemption.

**Grandfathering Provision**

In addition, the Rule as adopted, like the Proposed Rule, deems existing funds to be venture capital funds for purposes of the Rule, so long as the funds meet certain conditions. Under the grandfathering provision, a venture capital fund includes a private fund (1) that was represented to investors and potential investors at the time its securities were offered as a fund that pursues only capital appreciation; (2) whose securities were sold to one or more outside investors prior to December 31, 2010; and (3) whose securities were not being offered (including any uncommitted capital) from any person after July 21, 2011.

**Subject to Reporting Requirements and Exemptions**

A private fund seeking to rely on the venture capital exemption, while not subject to registration under the Advisers Act, is nonetheless an “exempt reporting adviser” for purposes of SEC rules and, as such, is required to maintain certain records as determined by the SEC and file, and periodically update, certain information with the SEC. At the same time that the SEC adopted the Rule, the SEC put in place a requirement that an exempt reporting adviser file, and periodically update, reports containing a limited subset of the information that must be reported by an investment adviser registered under the Advisers Act. Although adopted, the reporting requirements for advisers meeting the venture capital exemption proved to be controversial to the members of the SEC. Two commissioners – Casey and Paredes – cited the impact on advisers relying on the venture capital exemption as central to their determination not to support the adoption of the reporting requirements. In adopting the reporting requirements, the SEC also noted its authority to examine the records of an exempt reporting adviser. The SEC stated its staff will conduct examinations of exempt-reporting advisers as part of its overall strategies of wrongdoing, for instance, through tips, complaints or referrals, but indicated that it does not anticipate that the staff will conduct completeness examinations of non-exempt reporting advisers on a regular basis.}

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2. 17 CFR 203.1
3. The Rule as adopted, like the Proposed Rule, deems existing funds to be venture capital funds if the private fund in other private funds, whether U.S. or non-U.S., that meet the definition of venture capital fund includes a private fund.
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5. 17 See Release, at 41-42, 44-46.
6. See Chairman’s Statement.
7. 6 Id.
8. 4 Opening Statement at SEC Open Meeting: Dodd-Frank Act Amendments to the Investment Advisers Act. Chairman Mary Schapiro, June 22, 2011 (the “Chairman’s Statement”).
10. 10 Since venture capital funds typically make long-term investments that are disposed of after the fund’s investment period has been completed, the benefits of this aspect of the Rule may not be significant in practice.
11. See Release, at 13, 16-17.
12. 12 The Rule defines “equity security” by incorporating the definition in section 3(a)(11) of the Securities Exchange Act of 1934 and Rule 3a 110, which states that: “equity security” means any common stock, preferred stock, warrants, other securities convertible into equity and limited partnership interests.
13. See Release, at 22.
14. See Release, at 36. Under the Rule, a venture capital fund can continue to treat a previously acquired investment as such even if the applicable portfolio company subsequently becomes a reporting company.
17. See Release, at 49-50.
20. See Release, at 59-60.
22. 22 See Release, at 54.
23. See the definition of the term “private fund” in the text above under the heading “Operation of the Venture Capital Exemption.”
24. See Release, at 70.
29. Opening Statement at SEC Open Meeting: Dodd-Frank Act Amendments to the Investment Advisers Act. Chairman Mary Schapiro, June 22, 2011 (the “Chairman’s Statement”).
30. See Release, at 65.
31. See Chairman’s Statement.
32. The SEC has also said that identifying a fund as a hedge fund or venture capital fund is a capital is one of several strategies pursued by the fund, or including the fund in a hedge fund database or hedge fund index, would preclude an adviser from relying on the venture capital exemption.
33. See Release, at 29.
34. Since venture capital funds typically make long-term investments that are disposed of after the fund’s investment period has been completed, the benefits of this aspect of the Rule may not be significant in practice.
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37. See Release, at 22.
38. See the definition of the term “private fund” in the text above under the heading “Operation of the Venture Capital Exemption.”
39. See Release, at 70.