SEC Adopts Rule Defining "Venture Capital Fund" For Purposes Of Exemption From The Investment Advisers Act

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Many venture capital and private equity fund managers eagerly anticipated the recent adoption by the Securities and Exchange Commission (the "SEC") of Rule 203(l)-1[1] (the "Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") defining the term "venture capital fund" for purposes of implementing the "venture capital exemption" from registration under the Advisers Act created by the Dodd-Frank Wall Street Reform and Consumer Protection Act[2] (the "Dodd-Frank Act"). The exemption is of major consequence to such managers, as the ability of a manager to rely on the exemption determines 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[3] (the "Proposed Rule") by the SEC in November of last year. The Rule clearly offers a wider group of 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 considered:

> Our definition distinguishes venture capital funds from hedge fund and private equity funds by focusing on the lack of leverage of venture capital funds and the non-public, start-up nature of the companies in which they invest.
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> The rule therefore focuses on the provision of capital for the operating 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.[4]

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, with the result that their managers will be subject to Advisers Act registration unless they can rely on some other exemption or exclusion under the Act.

A discussion 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 adviser exemption" provided by existing Section 203(b)(3) of the Advisers Act. The private adviser exemption exempts an entity meeting 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 manager 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 longer than 120 calendar days, excluding certain guarantees by the fund of "qualifying portfolio company" obligations; (3) has 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 would be an investment company but for the exclusion from that definition under Section 3(c)(1) or Section 3(c)(7) of the 1940 Act.

Under 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 limited circumstances, in exchange for such directly acquired equity securities. The Rule defines a "qualifying portfolio company" as any company that: (1) is not a reporting or foreign-traded company (or in a control relationship with a reporting or foreign-traded company) at the time of the investment by the private fund; (2) does not incur leverage in connection with the investment by the private fund and distribute to the private fund the proceeds of the leverage in exchange for such investment; and (3) is not itself a fund or commodity pool.

Significant elements of the definition of a venture capital fund considered by the SEC in the adoption of the Rule are described below.

Representing Itself as Pursuing a Venture Capital Strategy

Under the Rule, a private fund must be represented to its investors and potential investors as pursuing a venture capital strategy in order to qualify as a venture capital fund. When adopting the Rule, the SEC made clear that determining whether this element of the Rule has been satisfied requires a facts and circumstances analysis based on all of the statements (and omissions) made by the manager to the fund's current and prospective investors.[5] According to the SEC, the goal of this element is to serve as a means of ensuring that only a fund that does not significantly differ from a traditional venture capital fund and is offered to investors as a fund that pursues a narrow venture capital strategy qualifies as a venture capital fund under the Rule.[6] The SEC has provided no comprehensive guidance regarding the phrase "venture capital strategy" but has identified certain characteristics of venture capital investing and activities: the lack of leverage; the non-public, start-up nature of the companies in which venture capital funds invest; and the manager's intent that the fund be used to provide capital for the operations and expansion of start-up businesses as opposed to the buying out of prior investors.[7] In addition, the SEC has indicated that if the strategy of a private fund contemplates holding investments that are not qualifying investments, the fund could be deemed not to be pursuing a venture capital strategy.[8] More ominously, the SEC has said that a manager that broadens the scope of a fund's investment activities to include non-qualifying investments after initially representing that the fund pursues a venture capital strategy would violate the antifraud provisions of the Advisers Act to the extent the fund's investment activity rendered those initial representations an untrue statement of a material fact.[9]

Basket for Non-Qualifying Investments

The most significant change in the definition of "venture capital fund" from what was set out in the Proposed Rule is the addition of a "basket" for non-qualifying investments, the effect of which is to enable a private fund to invest in a limited amount of investments that are not qualifying investments within the meaning of the Rule without falling outside of the definition. Under the Rule, a venture capital fund may hold up to 20 percent of its aggregate capital contributions and uncalled committed capital in non-qualifying investments (other than certain short-term holdings), as measured immediately after the acquisition of any asset, valued at cost or fair value, consistently applied. The fund's disposition of a non-qualifying investment (other than certain short-term holdings) will create more space in the basket for a fund to make additional non-qualifying investments.[10]

The basket of non-qualifying investments will certainly afford a venture capital fund flexibility in making investments, and will alleviate a manager's concern that one non-conforming investment within one of its funds would lead to it being unable to qualify for the venture capital exemption. The degree of flexibility, however, is lower than desired by some private fund industry members commenting on the Proposed Rule. In responding to these commenters, the SEC indicated that the size of the basket was 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.[11]

Equity Securities

The definition of a venture capital fund contained in the Rule as adopted contemplates the fund principally holding equity securities.[12] Under the Rule, investments in instruments other than equity securities must be counted toward the 20 percent basket for non-qualifying investments. The SEC is of the view that the definition of equity securities incorporated into the Rule is broad enough to include securities in which a venture capital fund typically invests.[13] 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 capital fund's typical 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 understanding that 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-

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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.[14] A venture capital fund within the meaning of the Rule can thus acquire equity securities from existing investors, including acquisitions of securities 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

Under the Rule, qualifying 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 may sell a portfolio company into the public markets once it has matured).[15] The Rule provides that a private fund seeking to qualify as a venture capital fund needs to fit investments in reporting companies, such as PIPE 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 that is 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 would therefore not be 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 company borrowing "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 specially delineating the types of leveraged transactions involving a venture capital fund that would result in a company being excluded from the definition of a qualifying portfolio company.[16] 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 noted, acquires controlling equity interests in portfolio companies through the buyout of existing security holders, or finances such investments or buyouts with borrowed money). 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.[17]

Investments in Operating Companies

The Rule excludes a private fund's investments in other private funds or other pooled investment vehicles from the definition of a qualifying investment. The SEC has stated that excluding these investments facilitated its intent to preserve the characterization of a venture capital fund as an entity specializing in long-term equity investments in small or start-up businesses.[18] Investments by a private fund in other private funds, including venture capital fund of funds, would thus need to be treated as coming within the fund's basket of non-qualifying investments. The SEC has taken the helpful position that a private fund seeking to rely on the venture capital fund exemption can disregard for purposes of the Rule a wholly owned intermediate investment vehicle formed for tax, legal or other regulatory reasons to hold the fund's investment in a qualifying portfolio company. But, the SEC has left unanswered the extent to which other forms of intermediate investment vehicles can be disregarded for purposes of the Rule.

Other Short-Term Holdings

The Rule provides that a venture capital fund does not need to include its investments in cash and cash equivalents, U.S. Treasuries with a remaining maturity of 60 days or less and shares of money-market mutual funds registered under the 1940 Act in the fund's basket of non-qualifying investments. The exclusion of these short-term instruments reflects the SEC's understanding that these instruments are typically held by a venture capital fund for cash management, and not investment, purposes.[19] However, debt issued by foreign governments, longer-maturity U.S. Treasuries and highly rated corporate commercial paper are non-qualifying investments and must come within a venture capital non-qualifying basket.

Limitation on Leverage

Under the Rule, a private fund will not qualify as a venture capital fund if the private fund borrows or otherwise incurs leverage in excess of 15 percent of the fund's aggregate capital contributions and uncalled committed capital. In addition, any such borrowing, indebtedness, guarantee or leverage must be for a non-renewable term of no longer than 120 calendar days (excluding certain guarantees of qualifying portfolio company obligations by the fund as discussed below). The SEC was asked by commenters on the Proposed Rule to increase the 15 percent leverage threshold or exclude certain other types of borrowings from the limitation. The SEC rejected the request, noting its understanding that a traditional venture capital fund would not typically incur borrowing in excess of 10 percent to 15 percent of its total capital contributions and uncalled commitment capital.[20] The SEC did exclude from the Rule's 120-day limitation any guarantee by a venture capital fund of qualifying portfolio company obligations up to the value of the fund's investment in the qualifying portfolio company. The SEC took this action in seeking to allow a venture capital fund to incur a limited amount of leverage in a manner consistent with the SEC's desire to exclude from the definition of such a fund other types of private funds that engage in trading strategies contemplating financial leverage likely to contribute to systemic risk.[21]

Miscellaneous Matters

Elimination of the Managerial Assistance Requirement

Under the Proposed Rule, a manager of a private fund attempting for a fund to be a venture capital fund for purposes of the Rule would have been required to offer (or provide) managerial assistance to, or control, each qualifying portfolio company in which the private fund invested. 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 assistance or control is not a key or distinguishing characteristic of venture capital investing.[22]

Inclusion of Non-U.S. Private Funds

As noted above, meeting the definition of venture capital fund requires that an entity be a private fund. The definition of private fund[23] in referencing Section 3(c)(1) and Section 3(c)(7) of the 1940 Act contemplates such a fund as generally 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 for purposes of the venture capital exemption to include a fund formed outside the United States the securities of which were not offered or sold in the United States or to 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, 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 solely 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 narrower than some 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 decided 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.[24]

Grandfathering Provision

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 this 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 a venture capital strategy; (2) whose securities were sold to one or more outside investors prior to December 31, 2010; and (3) whose securities were not sold to (including accepting any committed capital from) any person after July 21, 2011.

Subject to Reporting Requirements and Examination

A manager 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 such 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 into 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.[25]

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.[26]

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 where there are indications of wrongdoing, for instance, through tips, complaints or referrals, but indicated that it does not anticipate that the staff will conduct compliance examinations of exempt reporting advisers on a regular basis.[27]

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1 See Investment Advisers Act Release No. 3222, June 22, 2011 (the "Release"). The Rule is enacted under Section 203(l) of the Advisers Act as required by Section 407 of the Dodd-Frank Act.

2 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3 See Investment Advisers Act Release No. 3111, Nov. 19, 2010.

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").

5 See Release, at 65.

6 Id.

7 See Chairman's Statement.

8 The SEC has also said that identifying a fund as a hedge fund or multi-strategy fund (in which venture 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. See Release, at 65.

9 See Release, at 29.

10 Since venture capital funds typically make long-term investments that are disposed of after a 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 The Rule defines "equity security" by incorporating the definition of "equity security" in Section 3(a)(11) of the Securities Exchange Act of 1934 and Rule 3a11-1 under that Act. Included in the definition is common stock, preferred stock, warrants, other securities convertible into equity and limited partnership interests.

13 See Release, at 22.

14 See Release, at 23-25.

15 See Release, at 36. Under the Rule, a venture capital fund can continue to treat a previously acquired qualifying investment as such even if the applicable portfolio company subsequently becomes a reporting company.

16 See Release, at 46-48.

17 See Release, at 41-42, 44-46.

18 See Release, at 49-50.

19 See Release, at 33.

20 See Release, at 56-57.

21 See Release, at 59-60.

22 See Release, at 53-54.

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.

25 See Investment Advisers Act Release No. 3221, June 22, 2011 (the "Implementing Adopting Release").

26 See Statement at SEC Open Meeting – Rules Implementing Amendments to the Investment Advisers Act of 1940; Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Commissioner Kathleen L. Casey, June 22, 2011; Statement at Open Meeting to Adopt Final Rules Regarding Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign PrivateAdvisers and Final Implementing Amendments to the Investment Advisers Act of 1940, Commissioner Troy A. Paredes, June 22, 2011.

27 See Implementing Adopting Release, at 48.