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UPDATE – Recent Senate Legislation Retains Venture Capital Fund Exemption

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Sweeping financial overhaul passed by the U.S. Senate spares venture capital fund managers from new registration requirements that may hit the hedge fund community, requires periodic evaluation and adjustment of accredited investor standards, and disqualifies certain securities offerings from issuers affiliated with felons and other “bad actors” from the Regulation D safe harbor exemption from registration.

On May 20, 2010, the U.S. Senate passed the Restoring American Financial Stability Act of 2010 (the “Senate Bill”) to regulate the financial sector. Of particular interest to the venture capital community were (1) the new registration requirements under the Investment Advisers Act of 1940 (the “Advisers Act”) on investment advisers of “private funds,” (2) the new “accredited investor” standards, and (3) the new disqualification of issuers affiliated with felons and other “bad actors” from the Regulation D safe harbor to exempt certain securities offerings from the registration requirements of the Securities Act of 1933, as amended.

The Senate Bill retains the “venture capital fund” exemption (the “Venture Capital Fund Exemption”) from the new registration requirements under the Advisers Act that were contained in the financial reform bill passed by the U.S. House of Representatives on December 11, 2009 (the “House Bill”), and discussed in two prior Manatt newsletters (October 26, 2009, available [here](#), and December 14, 2009, available [here](#)). The Senate Bill requires the Securities and Exchange Commission (the “SEC”) to promulgate final rules to define the term “venture capital fund” within six months of the enactment of the new law. It is too early to tell how the SEC will define the term “venture capital fund.”

The Senate Bill also requires the SEC to review and adjust the “accredited investor” standard for inflation, and, commencing four years following enactment of the law, to review and readjust such standard no less frequently than once every four years thereafter. Currently, a natural person is an “accredited investor” if such person

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has income in excess of \$200,000 in each of the two most recent years (\$300,000 for a couple) or a net worth, or joint net worth with a spouse, in excess of \$1,000,000. Under the Senate Bill, the SEC must promulgate new regulations to exclude the value of a person's primary residence from the determination of such person's net worth. The Senate Bill further mandates that the net worth threshold shall remain \$1,000,000 (excluding the value of a person's primary residence) for four years following enactment of the law.

Finally, the Senate Bill disqualifies felons and other "bad actors" from the Regulation D safe harbor exemptions from the registration requirements of the Securities Act of 1933, as amended. In general, the disqualification will apply to issuers that are, or that have directors, officers, general partners or 10% beneficial owners that are, subject to certain punitive final orders by certain regulatory agencies, including the SEC, or that have been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the SEC. If enacted into law, this section of the Senate Bill will make it more difficult for felons and other "bad actors" to successfully form venture capital funds in the U.S. or for such persons or their venture capital funds to make investments in portfolio companies. A prior draft of the Senate Bill provided for a 120-day SEC review of all securities offerings that relied on the exemption from registration set forth in Section 506 of Regulation D. Many feared that imposing such a 120-day review period would significantly impair the flow of capital from venture capital funds and angel investors into the companies they fund. The Senate Bill was amended to remove the portion that mandated the 120-day review period and replace it with the "bad actor" disqualification described above. The final version of the Senate Bill represents a significant victory on this issue for the venture capital community.

The Senate Bill, like the House Bill before it, largely excludes the venture capital community from the most onerous aspects of the pending financial reforms. Venture capitalists may rejoice that the Venture Capital Fund Exemption in the House Bill has been retained in the Senate Bill. While the new "accredited investor" standards may make it more difficult for a new a new venture capital fund to raise capital, it will also increase the leverage of existing venture capital funds when negotiating terms with issuers that themselves will have more difficulty raising investment capital from natural persons. The disqualification of felons and other "bad actors" from the Regulation D safe harbor exemption from registration is unlikely to affect the majority of the venture capital community, and it can only help the good citizens by presenting new regulatory hurdles to felons and other "bad actors."

The Senate and House of Representatives will now bring their respective bills to conference to negotiate one final bill. President

Obama and leaders from both houses of Congress have indicated that they expect the final bill to be signed into law in early July 2010.

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