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How Venture Capital Fund Managers May Avoid Investment Adviser Registration . . . But Not Reporting

Fund Managers Should Submit Comments to the SEC

Venture capital fund managers now have an idea of the criteria that will permit continued exemption from investment adviser registration with the Securities and Exchange Commission. But even exempt managers will need to report substantial information to the SEC.

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The SEC has announced how it proposes to implement the exemption from registration for VC managers introduced by the Dodd-Frank Act.[1] In some respects the proposals are not consistent with customary investment practices. However, public comments on the proposal will be accepted through mid-January. The SEC Commissioners appear to be keeping an open mind, so industry participants should comment with the expectation of having a real impact on the final rules.

Private fund managers that are not exempt will be required to register by July 2011 since Dodd-Frank strips away the longstanding exemption on which most now rely.[2]

The "Venture Capital Fund" Exemption:

As proposed, a fund manager would be exempt from registration with the SEC if its only clients are "venture capital funds," each of which is a private fund that:

- represents to investors that it is a venture capital fund,
- only invests in (i) equity securities of "qualifying portfolio companies" (at least 80% of which were purchased directly from the issuer), (ii) U.S. Treasury securities with a remaining maturity of 60 days or less, and/or (iii) cash and cash equivalents,
- is not leveraged, other than with short-term debt not exceeding 15% of the fund's committed capital,
- offers to provide a significant degree of managerial assistance to, or controls, its portfolio companies, and
- does not permit redemption by its investors except in extraordinary circumstances.

A "qualifying portfolio company" is a private operating company that:

- is not an affiliate of a public company,
- does not borrow in connection with the fund's investment, and
- does not engage in any recapitalization or cash out of existing investors at the time of the fund's investment.

An existing VC fund may be grandfathered, even if it does not meet all the criteria for the new exemption, so long as it has held itself out to investors as a "venture capital fund." However, under the proposal, it could not issue any further interests, including accepting committed capital, after July 21, 2011.

As proposed, several of these conditions are not consistent with customary VC investment practices or may not be workable. For example:

- ordinary bridge financings would apparently be impermissible,
- recapitalizations, including pay to plays and antidilution adjustments, in connec-

1 The SEC's release with the text of the proposed rules may be found at sec.gov/rules/proposed.shtml.

2 The current exemption from SEC registration for investment advisers (including "private fund" managers) that have 14 or fewer clients will be eliminated in July 2011.

tion with the VC fund's investment, may be difficult or impossible,

- purchases of secondary directs would be limited,
- the management assistance requirement doesn't take into account that not all funds participating in a financing round offer such support, and
- the prohibition on issuing new interests after July 2011 would make the grandfather provision useless for many existing funds.

These are only proposals at this point. The SEC Commissioners made clear that the details of the final exemption are still in flux and that they will listen to industry comment. The release itself includes hundreds of questions about industry practice on which the SEC seeks input. Fund managers should seek to influence the rule-making process by submitting comments.

Smaller Fund Exemption; State Registration

Dodd-Frank also introduced a new exemption from SEC registration for fund managers with less than an aggregate of $150 million in assets under management. This could apply to a manager that couldn't fit within the venture capital exemption.

Note that (as now) a fund manager that it is exempt from SEC registration may still have to register with one or more states unless there is an applicable state law exemption.

Reporting Requirements for Exempt Managers

Managers relying on the new venture capital fund or less-than-$150m exemptions ("exempt reporting advisers") must comply with new reporting requirements to be adopted by the SEC. These will cover the following areas:

- identification of the manager, its owners and affiliates,
- characteristics of the funds,
- other business activities of the manager that present conflicts of interest, and
- disciplinary history of the manager and its employees.

These new SEC reporting requirements would apply even to an exempt reporting adviser that is required to register, or is exempt from registration, under its home state's law.

Exempt reporting advisers will file reports on the SEC's investment adviser electronic filing system (IARD), and these reports would be publicly available on the SEC's website.

It should be noted that the SEC is still considering expanding even further the reportable information about private funds as well as requiring additional record-keeping for exempt reporting advisers. Both of these areas are expected to be the subject of future rule making.

Several SEC Commissioners commented on the fact that exempt reporting advisers may also be subject to SEC examination under a strict reading of the statute, and asked specifically for comments on whether the proposed rules should address this.

Exempt fund managers will need to expand their supervisory / compliance procedures to ensure compliance with the elements of the exemption, as well as to cover the new reporting requirements.[3]

Reporting Requirements for Fund Managers that Must Register

The SEC is also proposing new reporting requirements for managers of hedge and private equity funds that do have to register as investment advisers. In addition to the current Form ADV requirements, the SEC proposes that such advisers would have to provide:

- Basic organizational and operational information about the funds they manage, such as information about the amount of assets held by the fund, the types of investors in the fund, and the adviser's services to the fund, and
- Identification of five categories of "gatekeepers" that perform critical roles for advisers and the private funds they manage (i.e., auditors, prime brokers, custodians, administrators and marketers).

These reporting requirements are designed to help identify practices that may harm investors and as a means to conduct a census of the private fund industry.

Actions to Take Now

Fund managers should submit comments to the SEC in order to ensure that the proposed "venture capital fund" definition doesn't hamper investing practices. Comments are due by mid-January and may be submitted individually or through industry groups.

VC fund managers who need to rely on the grandfather provision to fit under the new exemption should begin considering how to treat current investors with outstanding capital commitments that could be drawn after July 21, 2011.

Managers that do not fit within an exemption and will face registration should begin planning for the changes involved. In particular, they should organize the two principal projects – disclosure and compliance – and start making a careful assessment of the risks applicable to their business, which will inform the crafting of policies and procedures to address them.

[3] Fund managers and other investment advisers that are exempt from registration are subject to the antifraud provisions of the Investment Advisers Act and must have adequate supervisory procedures to ensure compliance with applicable law.

Our lawyers can help you formulate comments to the SEC and plan for the new compliance regime. If you would like further information, please contact the Edwards Angell Palmer & Dodge LLP lawyer responsible for your matters or one of the lawyers listed below.

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