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Venture Capital & Emerging Companies

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Draft Legislation Exempts VC Fund Managers From New Registration Requirements

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While waves of regulation are starting to crash down upon various financial industries, the venture capital community has been anxiously pondering its own fate. Would the venture industry, like the hedge fund industry, be deemed a major systemic risk to the financial system that requires regulation, even though venture capital funds typically do not trade in derivatives or leverage their investments with debt?

In what probably produced a collective, if uncertain, sigh of relief among venture capitalists, on October 1, 2009, legislation was introduced that would, if passed, likely keep the current venture capital environment free of major new regulation. The Private Fund Investment Advisers Registration Act of 2009 ("PFIARA"), introduced by Rep. Paul Kanjorski (D-PA), creates an exemption for advisers of venture capital funds from the proposed new registration requirements under the Investment Advisers Act of 1940 ("Advisers Act") that are expected to be imposed on advisers of other private pools of capital. The draft legislation represents the first sign that advisers of venture capital funds could be granted regulatory relief in the upcoming legislation. Such relief is not expected to be available to advisers of hedge funds and other private investment funds.

The PFIARA is the most recent attempt by Congress and the Obama Administration (the "Administration") to regulate the financial sector to minimize the systemic risks that Congress and the Administration believe led to the recent financial crisis. The Administration has identified the government's lack of reliable data about the activities of private investment funds as a material impediment to the government's ability to supervise and regulate financial firms. In order to gather more reliable data, the Administration seeks to compel more advisers of private investment funds to register with the Securities and Exchange Commission ("SEC") under the Advisers Act and to

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regularly record and report information on the funds they manage.

Under current law, most general partners and managing members of investment funds (including hedge funds, private equity funds and venture capital funds) operate under exemptions from the Advisers Act. Technically, advisers to private investment funds may be considered "investment advisers" under the Advisers Act because they are persons who, for compensation, engage in the business of advising others (their investment funds) as to the advisability of investing in, purchasing, or selling securities. Normally, investment advisers must register with the SEC pursuant to Section 203(a) of the Advisers Act. However, most advisers to private investment funds rely on the exemption from registration provided in Section 203(b)(3) of the Advisers Act (the "Section 203(b)(3) Exemption"). Broadly speaking, the Section 203(b)(3) Exemption exempts any investment adviser with fewer than 15 advisory clients from the registration requirements of Section 203(a). The SEC generally counts each investment fund as only one advisory client, so general partners and managing members of private investment funds routinely rely on the Section 203(b)(3) Exemption to avoid registration.

Earlier draft legislation before the PFIARA would have impacted venture capital funds. On January 27, 2009, Reps. Capuano (D-MA) and Castle (R-DE) introduced the Hedge Fund Adviser Registration Act of 2009, and on June 16, 2009, Sen. Reed (D-RI) introduced the Private Fund Transparency Act of 2009. Both bills sought to compel more investment advisers to register with the SEC by eliminating the Section 203(b)(3) Exemption for all investment advisers whose assets under management exceeded a modest threshold ($30 million under Sen. Reed's bill). Both bills and the Administration's plan for Financial Regulation Reform, which was published by the Department of the Treasury on June 17, 2009, generally sought to regulate all private investment fund advisers equally, without regard to the disparate systemic risk posed by the activities of each class of private investment fund. The PFIARA is noteworthy because it is the first bill that distinguishes advisers of venture capital funds from advisers of other investment funds and treats the two groups differently. Specifically, the PFIARA directs the SEC to identify and define the term "venture capital fund" and to provide the advisers of such funds with an exemption from the registration requirements of the Advisers Act that are to be imposed on other investment advisers. The PFIARA "recognizes that venture capital firms do not pose systemic financial risk and that requiring them to register under the Advisers Act would place an undue burden on the venture industry and the entrepreneurial community," said Mark Heesen, president of the National Venture Capital Association, which represents over 450 venture firms.

If the PFIARA is enacted without a venture capital exemption, or if the other draft legislation, which has no such exemption, is adopted, venture capital firms would likely experience a major operational burden. Unlike many other types of funds, venture capital funds, even rather large funds, tend to be leanly staffed and, almost by definition, operate by entrepreneurial practices that could be significantly impacted by federal regulation. It is conceivable that regulation could, over time, change the basic economics of the venture capital industry. For example, some companies might avoid investments from regulated funds, fearing disclosure of valuation and other sensitive information. At the same time, the incentives to managers of funds could be impacted, either toward accepting more risk,

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as a result of a desire to recoup added costs by placing riskier bets or, conversely, less risk, by putting a perhaps unwelcome spotlight on the successes and failures of fund investments. Moreover, registration with the SEC would increase administrative and legal expenses for fund managers and increase the liabilities associated with managing a venture capital fund.

It is too early to tell whether the venture capital fund exemption introduced by Rep. Kanjorski will be retained in the final bill or, if it is retained, how the SEC would define the term “venture capital fund.” However, the PFIARA gives venture capital fund advisers new reason to hope that they will be able to avoid the regulatory burden that may be imposed on hedge funds and private equity firms if any of the draft bills under consideration is enacted into law.

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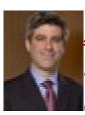

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