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SEC Adopts Rules Exempting Venture Capital Fund Advisers from SEC Registration and Setting Forth Reporting Regime

Advisers that solely advise funds that are able to fit the narrow definition of "venture capital fund" set forth by the SEC are exempt from registration requirements imposed by the Dodd-Frank Act, but are still required to comply with recordkeeping and reporting obligations.

July 7, 2011

On June 22, the U.S. Securities and Exchange Commission (SEC) adopted several rules implementing changes to the Investment Advisers Act of 1940 (Advisers Act) made by Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The new rules were adopted under a pair of companion releases: the first implemented changes for "mid-size" advisers and outlined reporting requirements of "exempt reporting advisers" (Implementing Release)[1] and the second promulgated exemptions from SEC registration for venture capital fund advisers, private fund advisers, and foreign private advisers (Exemptions Release).[2]

As a result of the new rules, previously unregistered advisers may have to register with the SEC or one or more state regulators absent an exemption from registration. Both venture capital advisers newly registering with the SEC or exempt from registration but subject to reporting requirements will have to file Form ADV (which will now cover both registered and exempt advisers) by March 30, 2012. For venture capital fund advisers exempt from registration, these reporting requirements will nonetheless include, among other things, disclosure of affiliated entities and extensive information about each of the adviser's venture capital funds.

SECTION 203(l) AND RULE 203(l)-1: EXEMPTION FOR "VENTURE CAPITAL FUND ADVISERS"

The Dodd-Frank Act amended Section 203(l) of the Advisers Act to provide an exemption from SEC registration requirements for any investment adviser that solely advises venture capital funds. There is no limit on the number of venture capital funds a venture capital fund adviser may advise and still

1. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Advisers Act Rel. No. 3221 (June 22, 2011), *available at* http://www.sec.gov/rules/final/2011/ia-3221.pdf. For the proposing release, *see* Rules Implementing Amendments to the Investment Advisers Act of 1940, Advisers Act Rel. No. 3110 (Nov. 19, 2010), *available at* http://www.sec.gov/rules/proposed/2010/ia-3110.pdf.

2. *See* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Advisers Act Rel. No. 3222 (June 22, 2011), *available at* http://www.sec.gov/rules/final/2011/ia-3222.pdf. For the proposing release, *see* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Advisers Act Rel. No. 3111 (Nov. 19, 2010), *available at* http://www.sec.gov/rules/proposed/2010/ia-3111.pdf.

qualify for the exemption; however, any non–venture capital fund client will disqualify an adviser from the exemption. In general, venture capital funds, according to Congress, are a subset of private investment funds and are typically unleveraged long-term investors in early stage or small, privately held companies, thereby limiting their ability to contribute to systemic financial risk.

The Dodd-Frank Act also directed the SEC to issue final rules to define the term "venture capital fund" for the purposes of the exemption and to require venture capital fund advisers to maintain records and provide the SEC with annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors.

In the Exemptions Release, the SEC adopted Rule 203(l)-1 under the Advisers Act, which (1) defines the term "venture capital fund," (2) sets forth a grandfathering provision for existing venture capital funds, and (3) defines additional terms used in the definition of "venture capital fund."

Definition of "Venture Capital Fund"

Under Rule 203(l)-1(a), a fund would have to meet *all* of the following five criteria in order to be considered a "venture capital fund":

1. ***The fund must be a private fund.***

In order to meet the definition of "venture capital fund" set forth in Rule 203(l)-1(a), the fund must be a "private fund," as defined in Section 202(a)(29) of the Advisers Act, as revised by the Dodd-Frank Act. Under Section 202(a)(29), a "private fund" is an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940 (1940 Act), but for the exclusions from the definition of "investment company" set forth in Section 3(c)(1) or 3(c)(7) of the 1940 Act.[3] The fund cannot be an investment company registered under Section 8 of the 1940 Act or elect to be treated as a business development company under Section 54 of the 1940 Act.

2. ***The fund must hold itself out to investors and potential investors as pursuing a venture capital strategy.***

In order to meet the definition of "venture capital fund," a fund must represent itself to the investing public as pursuing a venture capital strategy. As initially proposed, the exemption would have required funds to represent themselves as "venture capital funds." In the Exemptions Release, however, the SEC noted that a fund that does not refer to itself as a "venture capital fund," but nonetheless pursues a venture capital strategy, could still rely on the exemption from registration.

Determining whether a fund represents itself as pursuing a venture capital strategy will depend on the particular facts and circumstances, including all of the fund's statements and omissions made to investors and prospective investors in light of the circumstances under which they were made. Unlike the guidance surrounding the proposed rule, the adopted rule indicates that a fund that does not use the words "venture capital" in its name and is not inconsistent with pursuing a venture capital strategy would not be precluded from satisfying the definition of a venture capital fund by virtue of its name.

3. In general, the exclusions provided in Sections 3(c)(1) and 3(c)(7) of the 1940 Act apply to private funds with fewer than 100 investors or whose only investors are qualified purchasers.

Rather, a fund could still be considered a venture capital fund if the fund, through its statements, omissions, and representations, taken together, holds itself out as pursuing a venture capital strategy.[4]

3. *No more than 20% of the fund's assets may be invested in assets other than qualifying investments or short-term holdings.*

In order to be defined as a "venture capital fund," a fund can only invest up to 20% of its aggregate capital contributions and uncalled committed capital in assets other than "qualifying investments" and short-term holdings. This approach signals a change from the proposed definition, which required a fund to invest *solely* in qualifying investments and short-term holdings. The change was prompted by commenters that urged the SEC to permit venture capital funds the flexibility of investing a portion of their assets in debt instruments, publicly traded securities, shares of venture capital funds acquired on the secondary market, or other instruments that would not be "qualifying investments" but still be able to fit the definition of "venture capital fund." The 20% basket will also permit a venture capital fund to invest in nonqualifying securities as a means of providing bridge financing to portfolio companies between equity financings or for tax or structuring reasons.

The calculation of a fund's 20% basket occurs whenever a fund acquires such a nonqualifying asset. The SEC noted that a fund "need not dispose of a non-qualifying investment simply because of a change in the value of that investment."[5] Therefore, a nonqualifying investment that subsequently becomes worth more than 20% of the fund's assets will not disqualify the fund from venture capital fund status. In calculating its 20% basket, a fund may value such nonqualifying assets at either cost or fair value, but must consistently apply the selected valuation methodology. In other words, a fund cannot alternate between valuation methodologies in order to circumvent the limitations of the 20% basket.

Short-term holdings. A venture capital fund must invest at least 80% of its assets in "qualifying investments" and short-term holdings. Under Rule 203(l)-1(c)(6), "short-term holdings" are defined as cash, cash equivalents,[6] U.S. treasuries with remaining maturity of 60 days or less, and shares of registered money market funds. This definition expands the proposed definition, which would not have permitted a venture capital fund to invest in money market funds.

Qualifying investments. In general, a "qualifying investment" is any equity security of a "qualifying portfolio company" (QPC). "Equity security," in turn, is defined by reference to Section 3(a)(11) of the Securities Exchange Act of 1934 (1934 Act) and Rule 3a11-1 thereunder.[7] Therefore, eligible securities

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4. The SEC noted that venture capital funds undertaking nonpublic offerings in reliance on Regulation D must otherwise comply with the prohibitions on general solicitation and general advertising (i.e., statements made on a publicly accessible website).

5. Exemptions Release at 27.

6. Rule 203(l)-1(c)(6) refers to Rule 2a51-1(b)(7)(i) under the 1940 Act in defining "cash equivalents," which includes bank deposits, certificates of deposit, bankers acceptances, and similar bank instruments held for investment purposes. Rule 2a51-1(b)(7)(ii), which includes the net cash surrender value of an insurance policy within the definition of "cash equivalents," is not included in the definition of "cash equivalents" for the purpose of defining "venture capital fund."

7. Under Section 3(a)(11) of the 1934 Act, "equity security" is defined as "any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security." Under Rule 3a11-1, "equity security" is defined to include "any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any security convertible, with or without consideration into such a security, or

offered by a QPC in which a fund may invest include, among others, common or preferred stock, warrants, convertible securities, or interests in a limited partnership.[8] The proposed definition of "venture capital fund" would have required a fund to obtain at least 80% of its qualifying investments directly from the QPCs. As adopted, the rule permits a fund to acquire three types of qualifying investments, each of which suggests that the fund is financing a QPC's business operations rather than trading in secondary markets. Under Rule 203(l)-1(c)(3), "qualifying investments" include the following:

- Equity securities of a QPC directly acquired by the fund (Directly Acquired QPC Equity)
- Equity securities of a QPC acquired by the fund in exchange for Directly Acquired QPC Equity
- Equity securities of a company of which a QPC is a majority-owned subsidiary or a predecessor and acquired by the fund in exchange for either Directly Acquired QPC Equity or equity securities acquired in exchange for Directly Acquired QPC Equity

This definition permits a fund to participate in the reorganization of the capital structure of the fund's portfolio companies (e.g., to exchange old shares for new shares of the same QPC) or to acquire securities in connection with the acquisition or merger of the fund's portfolio companies (e.g., to exchange shares of the QPC in exchange for shares of the surviving company that has acquired the QPC), or both.

If a fund invests in debt instruments of a QPC that cannot be characterized as "equity securities" under the 1934 Act, then such debt instruments would count toward the fund's 20% basket. A fund could provide a QPC with "bridge financing" in anticipation of future investment in exchange for instruments that are ultimately convertible into stock of the QPC without having to count such convertible instruments toward the fund's 20% basket. Any bridge financing by a fund to a QPC in exchange for an instrument that is not an "equity security," however, would have to be counted toward the fund's 20% basket, as previously mentioned.

Qualifying portfolio companies. Under Rule 203(l)-1(c)(4), a company would have to meet *all* of the following criteria in order to be considered a QPC:

> *a. At the time of any investment by the fund, the company was not reporting or foreign traded and did not control, was not controlled by, and was not under common control with another company, directly or indirectly, that is reporting or foreign traded.*

A QPC cannot be a "reporting or foreign traded" company, or control, be controlled by, or be under common control with a reporting or foreign-traded company, at the time of the fund's initial investment in the company. "Reporting company" means a company subject to the reporting requirements of Section 13 or 15(d) of the 1934 Act. "Foreign traded company" means a company with securities listed or traded on a foreign exchange or organized foreign market.

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carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so."

8. Although not specifically enumerated in the definition of "equity security" set forth in Section 3(a)(11) of the 1934 Act and Rule 3a11-1 thereunder, we note that membership interests in a limited liability company would, depending on the particular facts and circumstances, likely be considered "equity securities." Therefore, a membership interest in an LLC would typically be a satisfactory structure for a qualifying investment. In the event that such an LLC membership interest was not deemed an "equity security," a venture capital fund would have to count the value of its interest toward its 20% nonqualifying basket.

A fund may continue to hold securities of a QPC that goes public after the fund's investment and thereby becomes a reporting company. In addition, a fund can make additional investments in a QPC after it goes public. The ability to continue investing in a QPC after it goes public deviates from the proposed rule, which would have required a fund to dispose of a QPC's securities once it went public in order to still qualify as a "venture capital fund." In the Exemptions Release, the SEC acknowledged that "an existing investment in a portfolio company that ultimately becomes a successful venture capital investment (such as when the company issues it securities in a public offering or becomes a reporting company) should not result in the investment becoming a non-qualifying investment."[9] The SEC noted that a fund's portfolio could consist entirely of securities of reporting companies and the fund could still qualify as a "venture capital fund" under Rule 203(l)-1 so long as the fund invested in the QPCs' securities prior to each QPC becoming a reporting company.

In the proposed rule, the SEC sought to limit QPCs to companies that were not "publicly traded," but the adopted Rule 203(l)-1 uses the term "reporting or foreign traded" to clarify that certain companies that have issued securities that trade on a foreign exchange are also covered by the definition.

In response to comments received on the proposing release, the SEC noted that although venture capital funds typically invest in small, startup companies, these concepts were not built into the definition of "venture capital fund" due to a lack of consensus in defining such concepts, the possibility of ignoring business complexities by putting in place standardized metrics (e.g., net income, number of employees), and a concern that promising companies would be eliminated from possible investment by venture capital funds as a result. Finally, the SEC considered, but did not adopt, the definitions of "venture capital fund" used by the California Corporations Commission and U.S. Department of Labor, both of which permit a fund to invest in publicly traded companies and permit a fund to invest up to 50% of its assets in nonoperating companies (i.e., investment funds).

b. The company does not borrow or issue debt obligations in connection with the fund's investment and then distribute to the fund the proceeds of such borrowing or debt issuance in exchange for the fund's investment.

A company will not meet the definition of a QPC if it borrows money, issues debt, or otherwise incurs leverage in connection with the fund's investment and also distributes the proceeds of such borrowing or debt issuance to the fund in exchange for the fund's investment. A company may, however, borrow money as part of its normal course of business (i.e., to invest in infrastructure, finance inventory, or make payroll) and still qualify as a QPC. This "in connection with the fund's investment" requirement is aimed at preventing advisers to leveraged-buyout funds from relying on the venture capital fund advisers exemption since, according to the SEC, leveraged-buyout funds present a greater systemic risk than venture capital funds. The same rationale was the basis for an additional prong of the proposed rule's definition of "QPC" that was not adopted, which would have prohibited a QPC from redeeming, exchanging, or repurchasing its securities, or distributing cash or other assets to preexisting security holders, directly or indirectly, in connection with a fund's investment. In creating the 20% basket, the rule, as adopted, effectively moved these limitations from the definition of "QPC" to the definition of "venture capital fund."

c. The company is an operating company.

9. Exemptions Release at 40.

In order to meet the definitional requirements of a QPC, a company cannot be a private fund or other pooled investment vehicle, including an investment company, an investment company relying on Rule 3a-7 under the 1940 Act, or a commodity pool. In short, the company must be an operating company in order to qualify as a QPC. The SEC dismissed the application of the venture capital fund adviser exemption to venture capital fund-of-funds structures, noting that Congress provided no indication that it intended the scope of the exemption to reach such structures. Nonetheless, a fund many invest in other investment vehicles with its 20% basket. The SEC also noted that a fund may disregard a wholly owned intermediate holding company formed solely for tax, legal, or regulatory reasons to hold the fund's investment in a QPC. There is no requirement that the QPC be a U.S. company, although a fund may not make an initial investment in a company traded on a foreign exchange or organized market operating in a foreign jurisdiction.

4. ***The fund cannot borrow, issue debt obligations, provide guarantees, or otherwise incur leverage in excess of 15% of its aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee, or leverage must be for a nonrenewable term of no longer than 120 calendar days, except that any guarantee by the fund of a QPC's obligations up to the amount of the fund's investment in the QPC is not subject to the 120-calendar-day limit.***

In order to meet the definition of "venture capital fund," a fund cannot borrow, issue debt obligations, provide guarantees, or otherwise incur leverage in excess of 15% of its aggregate capital contributions and uncalled committed capital. If the fund does conduct such leveraging activities, it must be for a nonrenewable term of no longer than 120 calendar days. The SEC noted in the proposing release that a fund may issue short-term debt, such as commercial paper, and still be considered a "venture capital fund."

Because the 15% threshold is calculated as 15% of the fund's aggregate capital contributions and uncalled capital commitments, it would be possible for the fund to leverage an acquisition of QPC securities up to 100% so long as the invested amount does not exceed 15% of the fund's total capital commitments. All such leverage would still be limited to 120 days or less. Excluded from the 120-calendar-day limit, however, are guarantees by the fund as to a QPC's obligations up to the amount of the fund's investment in the QPC. This change from the proposed rule was based on the rationale that a fund's guarantee of a QPC is for operational purposes (i.e., assisting the QPC in obtaining credit) and not used to leverage the fund's investment in the QPC.

5. ***The fund must only issue securities that do not provide investors with any right (except in extraordinary circumstances) to withdraw, redeem, or require the repurchase of such securities.***

Outside of extraordinary circumstances, a fund cannot require investors to sell securities back to the fund or grant investors the right to redeem or withdraw their securities. Extraordinary circumstances could include changes in the law that would affect investors' tax treatment or ability to invest in particular countries and industries, or foreseeable but unexpected corporate events, such as mergers. If the fund offers quarterly or periodic withdrawal rights, it cannot qualify as a "venture capital fund," even if the fund has a temporary initial lock-up period or other restriction on the right to redeem. Rule 203(l)-1 does not set forth any specific time period for which fund interests must be held, though the SEC noted in the proposing release that industry practice is usually 10 years.

Grandfathering Provision

Rule 203(l)-1(b) also exempts an adviser to a fund that does not meet the definition of “venture capital fund” but that is a private fund that (1) represented to investors and potential investors at the time it offered its securities that it pursued a venture capital strategy, (2) sold securities to one or more investors prior to December 31, 2010, and (3) does not sell securities (including additional capital commitments) to any person after July 21, 2011. The SEC specified that in order to meet the grandfathered exemption, capital commitments from the fund’s investors need not be called by July 21, 2011 as long as the investors became obligated by July 21, 2011 to make a future capital contribution. The grandfathering provision, as adopted, is slightly more expansive than the proposed grandfathering provision in that a fund need not have held itself out to be a “venture capital fund,” but instead must have held itself out as pursuing a “venture capital strategy.” Nonetheless, the SEC noted that it does not expect that advisers identifying themselves as “private equity” or “hedge” funds will be able to rely on the grandfathering provision.

Other Items

- The SEC noted in the proposing release that the rule would not require an adviser to provide a capital contribution to its fund, does not specify a minimum investment term, and does not exclude funds that permit investment by retail investors.

- The SEC also stated that an adviser with its principal place of business outside the United States may rely on the exemption if all of its clients—whether U.S. or non-U.S. clients—are venture capital funds. Nonetheless, because “private fund” is defined by reference to Section 3 of the 1940 Act, a non-U.S. fund that does not conduct an offering in the United States could not be a “private fund” and therefore could not qualify as a “venture capital fund.” The SEC added a note to Rule 203(l)-1 that specifies that a fund formed outside the United States and not offered or sold in the United States or to U.S. persons may be considered a “private fund” by the adviser, so long as the adviser treats the fund as a private fund for all purposes (i.e., Form ADV reporting).

- The SEC did not adopt the proposed definitional requirement that a fund must directly or indirectly control each QPC or otherwise arrange to offer (and, if accepted, provide) managerial guidance and counsel to each QPC. The SEC staff noted that this requirement would have been difficult to apply and did not distinguish venture capital funds from other types of funds.

- The exemption provided to advisers of venture capital funds under Rule 203(l)-1 is not mandatory and such advisers may voluntarily register. Unregistered venture capital fund advisers may still be subject to state registration requirements, as Section 203A(b)(1) of the Advisers Act only provides an exemption from state registration requirements to advisers that are registered with the SEC.

New Reporting Requirements for Venture Capital Fund Advisers as “Exempt Reporting Advisers”

Section 203(l) of the Advisers Act, as amended by the Dodd-Frank Act, mandates that the SEC require venture capital fund advisers that are exempted from registration to nonetheless maintain records and provide the SEC with reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors. In the Implementing Release, the SEC adopted Rule 204-4 under the Advisers Act requiring venture capital fund advisers and private fund advisers, referred to as “exempt reporting advisers," to complete and electronically file reports using the Investment Adviser Registration Depository (IARD) system on certain amended items set forth in Form ADV, which will be made publicly available on the SEC's website.[10]

New Reporting Requirements

The items in Form ADV on which exempt advisers must report within 60 days of relying on either exemption from registration are the following:

- **Item 1 – Identifying Information.** An exempt reporting adviser must disclose information such as its principal place of business, website address, name and contact information of its chief compliance officer, registration status with any foreign financial regulatory authority, and status as a public reporting company under the 1934 Act.
- **Item 2B – Identification of Exemption.** An exempt reporting adviser must identify the exemption that it is relying on to report to, rather than register with, the SEC.
- **Item 3 – Form of Organization.** An exempt reporting adviser must disclose its corporate form (e.g., limited liability company), the state under which the adviser is organized, and the month in which its fiscal year ends.
- **Item 6 – Other Business Activities.** An exempt reporting adviser must disclose other businesses in which it is actively engaged (e.g., broker-dealer, commodity pool operator, futures commission merchant, major security-based swap participant) and whether the adviser sells products or provides services other than investment advice to its advisory clients.
- **Item 7A and Section 7A of Schedule D – Related Persons.** An exempt reporting adviser must provide information about whether its related persons, including foreign affiliates, are financial industry participants (e.g., broker-dealer, other investment adviser, futures commission merchant). In the Implementing Release, the SEC removed "investment company" from the list of affiliates and added "registered municipal advisor," "registered security-based swap dealer," "major security-based swap participant," "trust company," and "sponsor, general partner, managing member (or equivalent) of pooled investment vehicles." The SEC also clarified that an adviser must report affiliates that are (i) either registered ***or exempt*** commodity pool operators or commodity trading advisors or (ii) either registered ***or unregistered*** broker-dealers, municipal securities dealers, or government securities brokers or dealers. For each such related person, an exempt reporting adviser must also provide additional information, including any control relationships between the related person and the exempt reporting adviser, under Section 7A of Schedule D to Form ADV. This expansion of the categories of related affiliates, coupled with the addition of reporting requirements for foreign affiliates, represents a substantial increase in the scope of information reported to the SEC. In the Implementing Release, the SEC noted that the information provided in response to Item 7A will provide the SEC "with details regarding other business activities in which the adviser and its affiliates are engaged, which would permit [the SEC] to identify conflicts that the adviser may have with its clients that may suggest significant risks to those clients."[11]
- **Item 7B and Section 7B of Schedule D – Private Funds.** The Implementing Release adopted a revised Item 7B, which requires both registered and exempt reporting advisers to state whether

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10. Part 1A of Form ADV, including Schedules A, B, C, and D, as amended by the Implementing Release, is filed as Appendix D of the Implementing Release, *available at* http://www.sec.gov/rules/final/2011/ia-3221-appd.pdf.

11. Implementing Release at 46.

they advise private funds. Advisers to venture capital funds must then make a Section 7B of Schedule D filing for each such venture capital fund, which requires disclosure of substantial information about the fund including, among other things, its jurisdiction of organization, general partners, managers, trustees or directors, beneficial ownership, service providers, reliance on Regulation D offerings, and current gross asset value.

Advisers that use a numerical or alphabetical code on their books and records to preserve the anonymity of venture capital fund clients may report the same code on Schedule D in place of the private funds' names. The amendments to Form ADV set forth in the Implementing Release also put in place certain procedures to avoid dual reporting where a private fund may use subadvisers or is part of a master-feeder structure. In addition, a non-U.S. adviser (i.e., an adviser with a principal office and place of business outside the United States) is not required to complete Schedule D for any private fund that, during the adviser's last fiscal year, was not a U.S. person, beneficially owned by a U.S. person, or offered in the United States. This new regime represents a substantial increase in the reporting requirements of venture capital fund advisers—a fact that led two of the five SEC Commissioners to vote against its adoption.

- **Item 10 – Control Persons.** An exempt reporting adviser must disclose the identity of every person who directly or indirectly controls the adviser or its management policies. Form ADV defines "control" as the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract or otherwise, and presumes control upon ownership of 25% of the adviser's voting interests.
- **Item 11 – Disclosure Information.** An exempt reporting adviser must disclose its disciplinary history as well as that of its employees.

Other Considerations

- Exempt reporting advisers must file their initial Form ADV reports through IARD between January 1, 2012 and March 30, 2012. After March 30, 2012, new exempt reporting advisers will have to file their initial Form ADV within 60 days of relying on the exemption.
- Under Rule 204-1, as amended by the Implementing Release, an exempt reporting adviser would be required to amend its Form ADV annually within 90 days of its fiscal year-end.
- Information in Items 1, 3, and 11 that becomes inaccurate in any way must be promptly updated. Information in Item 10 that becomes materially inaccurate must be promptly updated.
- Advisers no longer operating as exempt reporting advisers (due to voluntary registration, cessation of business, or failure to continue to qualify for the applicable exemption) must file a "final report" with the SEC, which will permit the SEC to distinguish between compliant and noncompliant exempt reporting advisers.
- An SEC-registered adviser that is deregistering in reliance on the venture capital fund adviser exemption must file a Form ADV-W to withdraw its SEC registration prior to submitting its first exempt reporting adviser report.
- Non-U.S. advisers relying on either exemption from registration will be able to appoint the Secretary of the SEC as agent for service of process under Form ADV-NR.
- An exempt reporting adviser that is unable to electronically file Form ADV due to technical difficulties may request a seven-business-day temporary hardship exemption.
- An exempt reporting adviser will have to pay a filing fee, which is expected to range from $40 to $225 based on its assets under management.

- In the proposing release, the SEC noted that because venture capital fund advisers are not "specifically exempt" from the registration requirement under Section 203(b) of the Advisers Act, their books and records will still be subject to SEC examination under Section 204(a). The books and records of foreign private advisers, on the other hand (as further discussed below), which are specifically exempt from registration under Section 203(b)(3), would not be subject to SEC examination. In the Implementing Release and in SEC Chairman Mary L. Schapiro's speech regarding the adoption of the Exemptions and Implementing Releases, it was noted that the SEC does not expect to conduct regular compliance examinations of exempt reporting advisers, although it retains the authority to do so.[12]
- Chairman Schapiro, in her remarks announcing the Exemptions and Implementing Releases, indicated that the SEC staff would revisit the exempt reporting adviser disclosure regime after receiving the first year's filings to determine whether any adjustments are necessary or if the staff is not receiving sufficient information.
- The Implementing Release noted that the SEC will address recordkeeping requirements for exempt advisers in a future release.[13]

PRACTICAL CONSIDERATIONS FOR U.S. VENTURE CAPITAL FUND ADVISERS

The combination of the elimination of the *de minimis* exemption (the 15-client rule), upon which many venture capital fund managers currently rely, and the new explicit carveout from any registration requirements for venture capital fund advisers means that a venture capital fund adviser will no longer be limited to fewer than 15 clients (i.e., 15 venture capital funds). Consequently, venture capital fund advisers that are self-constrained by the 15-client rule so as to avoid registration will no longer be limited by the number of funds they can manage, so long as all of the funds they manage meet the definition of "venture capital fund." Nonetheless, although still not registered, such managers will be subject to the additional reporting requirements and will continue to be subject to the antifraud provisions of the Advisers Act.

Venture capital fund advisers should consider altering practices and limiting activities so as to conform to the proposed definition of "venture capital fund." For example, advisers may want to make their representations to the public more explicit so as to meet the requirement that they represent themselves as pursuing a venture capital strategy. Advisers will also have to install policies and procedures to ensure that the companies they invest in are QPCs and that the equity securities of QPCs they invest in are either acquired directly from the QPC or in exchange for such directly acquired securities as part of a capital restructuring or merger or acquisition.

Venture capital fund advisers should begin structuring their systems to categorize and track "qualifying investments," "short-term holdings," and "non-qualifying investments." Further, advisers will have to

12. *See* Remarks by Chairman Schapiro: Opening Statement at SEC Open Meeting: Dodd-Frank Act Amendments to the Investment Advisers Act (June 22, 2011), *available at* http://www.sec.gov/news/speech/2011/spch062211mls-items-1-2.htm ("In addition, although the law enables the Commission to examine these 'exempt but reporting advisers,' we do not intend to conduct routine examinations of them. As many observers know, the Commission has scarce resources, and it is important therefore that we target those resources toward the advisers that are actually registered with us, where the investing public expects us to be focused. At the same time, if there are indications that we should conduct an on-site visit of an exempt but reporting investment adviser, we legitimately and appropriately will have the ability to do so.").

13. *See* Implementing Release at n.163. Section 204(b) of the Advisers Act, as amended by the Dodd-Frank Act, states that the SEC may require registered investment advisers to maintain records and file reports regarding the amount of assets under management, use of leverage (including off-balance-sheet leverage), counterparty credit risk exposure, trading and investment positions, trading practices, valuation policies and practices, types of assets held, and side arrangements.

employ policies and procedures designed to calculate and track their funds' 20% baskets and to halt the acquisition of additional investments that are identified as "non-qualifying investments" once a fund reaches its 20% maximum so as to retain its ability to qualify as a venture capital fund under Rule 203(l)-1.

Advisers may want to consider building into their purchase agreements for shares that the QPC will use the funds for operating and business purposes and not to buy out shareholders. If an individual QPC does intend to use a portion of its funds to provide liquidity to an angel investor, this should be noted by the adviser and the QPC during the purchase of the QPC's securities.

Advisers will also have to ensure that QPCs do not borrow money outside of the normal course of business or issue any debt securities in connection with the fund's investment and then distribute the proceeds of such borrowing or debt issuance to the fund.

Regardless of whether an adviser qualifies for exemption from registration with the SEC, all venture capital fund advisers will be subject to the reporting requirements set forth in the Implementing Release, including the proposed revisions to Item 7B and Schedule D of Form ADV, which would require advisers to provide identifying information about each of their private funds, such as each fund's name and domicile, ownership, service providers, and assets. Venture capital fund advisers, as discussed above, would also be subject to examination by the SEC, although the SEC does not currently contemplate employing a routine examination regime.

ADDITIONAL INFORMATION

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact the authors, **Ethan W. Johnson** (305.415.3394; ejohnson@morganlewis.com), **Monica L. Parry** (202.739.5692; mparry@morganlewis.com), **Trina C. Winkelmann** (202.739.5254; twinkelmann@morganlewis.com), **Abigail Bertumen** (202.739.5945; abertumen@morganlewis.com), and **John J. O'Brien** (215.963.4969; jobrien@morganlewis.com), or any of the following Morgan Lewis attorneys:

New York		
Louis H. Singer	212.309.6603	lsinger@morganlewis.com
Jedd H. Wider	212.309.6605	jwider@morganlewis.com
Philadelphia		
Timothy W. Levin	215.963.5037	tlevin@morganlewis.com
Princeton		
Steven M. Cohen	609.919.6604	scohen@morganlewis.com
San Francisco		
Paul C. McCoy	415.442.1385	pmccoy@morganlewis.com
Peter M. Phleger	415.442.1096	pphleger@morganlewis.com
Washington, D.C.		
Thomas S. Harman	202.739.5662	tharman@morganlewis.com
Steven W. Stone	202.739.5453	sstone@morganlewis.com

In addition, Morgan Lewis's multidisciplinary Financial Regulatory Reform resource team is available to assist with a wide range of issues and areas of concern related to the reform effort. You can access a complete collection of the firm's updates and alerts on the subject on our website's Financial Regulatory Reform page.

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