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SEC Proposes Rules to Implement Game-Changing Provisions for Venture Capitalists

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The Securities and Exchange Commission (the "SEC") recently proposed rules to implement changes to the Investment Advisers Act of 1940 (the "Advisers Act") required by passage of the Dodd-Frank Wall Street Reform Consumer Protection Act (the "Dodd-Frank Act").[1]

If adopted in their current form, the proposed rules will significantly expand the universe of venture capital funds that may be required to register as investment advisers and increase the compliance and regulatory costs for those funds. In addition, venture capital funds and their management teams, who seek to comply with the new exemptions available under the Advisers Act, will be required to closely monitor their business activities to ensure that they do not run afoul of the new regulations.

Even if an investment adviser is exempt from registration under the Advisers Act, it will still be subject to certain SEC reporting requirements under the proposed rules. Exempt advisers (i.e., those qualifying for the Venture Capital Exemption or the Private Fund Adviser Exemption, each as defined below) will be required to electronically file, and periodically update, reports with the SEC on Form ADV.[2] The SEC may use these filings to identify potential risks posed to investors in funds managed by the exempt advisors.

Managers and directors of venture capital funds are encouraged to use the SEC's comment process to provide input on the final form these rules will take.

Background

The Dodd-Frank Act repealed the so-called "private adviser exemption" of the Advisers Act. Under this exemption, an investment adviser did not have to register under the Advisers Act if it (i) had fewer than 15 clients in the preceding 12 months, (ii) did not hold itself out to the public as an investment adviser, and (iii) did not act as an investment adviser to a registered investment company or a company that had elected to be a business development company. This exemption has historically been used by the general partners and managers of most venture capital funds to free them from having to comply with the Advisers Act.

In place of the private adviser exemption, the Dodd-Frank Act added three new exemptions for:

- advisers solely to venture capital funds, without regard to the actual number or size of such funds advised by the adviser (the "Venture Capital Exemption");
- advisers to private funds with less than $150 million in assets under management in the United States (the "Private Fund Adviser Exemption"); and
- non-U.S. advisers with less than $25 million in aggregate assets under management from U.S. clients and private fund investors and fewer than 15 such clients and investors.

The proposed rules are intended to define or clarify the meaning of certain terms for purposes of implementing the foregoing exemptions and to provide the framework for implementation of the Private Fund Adviser Exemption.

This client advisory will focus on the proposed rules related to the Venture Capital Exemption and the Private Fund Adviser Exemption.

Venture Capital Exemption

The Dodd-Frank Act amended the Advisers Act to provide that an investment adviser that solely advises "venture capital funds" is exempt from registration requirements. The rules proposed by the SEC define a venture capital fund for purposes of the Venture Capital Exemption as a private fund that:

- invests only in (i) "equity securities" of "qualifying portfolio companies" and (ii) cash and cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less;
- with respect to its investments in equity securities, acquires at least 80% of each company's securities directly from the qualifying portfolio company;
- directly, or through its investment advisers, offers or provides significant managerial assistance to or controls the qualifying portfolio company;
- does not borrow or otherwise incur leverage other than limited short-term borrowings (as described below);
- does not offer to its investors redemption or other similar liquidity rights;
- represents itself as a venture capital fund to investors; and
- is not registered under the Investment Company Act of 1940 (the "1940 Act") and has not elected to be treated as a business development company.

Under the proposed rules, "qualifying portfolio companies"[3] cannot be publicly traded at the time of investment and must use the capital provided by the venture capital fund for business expansion rather than to buy out other investors. Accordingly, as proposed, a venture capital fund could not initially buy the securities of a small publicly traded company to add to its portfolio even if that public company had many of the same characteristics (revenue, business model, expansion opportunity) as a private company.

"Equity securities"[4] are broadly defined to include common stock, preferred stock, warrants, and other securities convertible into capital stock. However, investments in straight debt instruments (i.e., nonconvertible debt) would not be permitted for private funds under the Venture Capital Exemption. Rather, private funds under the Venture Capital Exemption would be permitted to invest in debt instruments that are convertible into equity securities of the portfolio company. This would generally allow private funds to extend traditional convertible bridge financing and still qualify for the Venture Capital Exemption, but private funds that extend nonconvertible debt financing, regardless of the length of the term of such debt, would disqualify themselves from the Venture Capital Exemption.

To qualify as a venture fund under the Venture Capital Exemption, the proposed rules require that a private fund acquire at least 80% of each of its portfolio company's securities directly from such portfolio company rather than on a secondary basis. This requirement would preclude investments in certain portfolio companies where the private fund's investment is made in connection with a recapitalization of the portfolio company. The proposed rules include two examples of portfolio companies that would not be considered qualifying portfolio companies under the Venture Capital Exemption as a result of certain recapitalizations. The first example involves an investment by a private fund that occurs concurrently with the portfolio company's redemption of its existing shareholders using the proceeds from the investment to pay the redemption amounts. The second example involves existing shareholders receiving new securities that are subordinate to the securities issued to the private fund. Under this example, some portion of the investment proceeds from the private fund would be used by the portfolio company as consideration for the shares tendered by its existing shareholders. The SEC, however, notes in the proposed rules that a capital reorganization intended to merely simplify a qualifying portfolio company's capital structure and outstanding securities without any change in the existing shareholders' rights, priority, or economic terms would not be considered a breach of the 80% condition under the Venture Capital Exemption.

The proposed rules also require that the private fund or its investment adviser (i) have an arrangement under which it offers to provide significant guidance and counsel concerning the management, operations or business objectives and policies of the portfolio company, or (ii) control the portfolio company. The proposed rules do not require a certain level of managerial assistance by the private fund or its investment adviser in order for the private fund to qualify as a venture capital fund; rather, the proposed rules require only that the private fund or its investment adviser offer assistance to each portfolio company held by a private fund.[5] Finally, although there may be an understanding among private funds investing in a portfolio company as a group (for example, an outside fund together with an inside "side fund") that one adviser among the group may provide most of the managerial assistance to such portfolio company, the proposed rules require that each private fund (or its investment adviser) offer managerial assistance to, or exercise control of, the portfolio company in order for such private fund to qualify as a venture capital fund under the Venture Capital Exemption.

In addition, to fall within the definition of a venture capital fund under the proposed rules, a private fund would not be permitted to borrow, issue debt obligations, provide guarantees, or otherwise incur leverage in excess of 15% of such private fund's aggregate capital commitments. Moreover, the proposed rules require that any such borrowing, indebtedness, guarantee, or leverage with respect to the private fund be for a nonrenewable term of no longer than 120 calendar days. Under the restrictions outlined in the proposed rules, a private fund's ability to use a revolving line of credit (e.g., for use as a bridge between outstanding capital calls) would be significantly limited.

To qualify for the Venture Capital Exemption, a private fund may also not provide its investors with any redemption or other liquidity rights except in extraordinary circumstances. While investors in private funds would be entitled to receive pro rata distributions under the proposed rules, they would not be entitled to have their interests redeemed or require the repurchase of such interests other than in extraordinary circumstances (i.e., circumstances beyond the control of the adviser and investor such as a change in tax law subsequent to an investor's purchase of interests in the private fund, or enactment of any laws that may prohibit an investor's participation in the fund).

Grandfathering Provision for Existing Venture Capital Funds

The proposed rules include a grandfathering provision for certain existing private funds to qualify under the Venture Capital Exemption. In order to avail itself of the grandfathering provision, a private fund must:

- have represented to investors and potential investors at the time the private fund offered its securities that it is a venture capital fund;
- sell securities to one or more investors prior to December 31, 2010; and
- not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011.[6]

Private Fund Adviser Exemption

Under the Private Fund Adviser Exemption, an investment adviser will be exempt from registration under the Advisers Act if such investment adviser solely advises qualifying private funds[7] and has assets under management in the United States of less than $150 million.

While an investment adviser under the Private Fund Adviser Exemption can advise an unlimited number of private funds (so long as the aggregate value of the investment adviser's private fund assets is less than $150 million), if any of the private funds are not a qualifying private fund, the investment adviser will need to register under the Advisers Act or qualify for an exemption other than the Private Fund Adviser Exemption.

To qualify under the Private Fund Adviser Exemption, an investment adviser with a principal office and place of business[8] in the United States (i.e., a "U.S. adviser") would have to satisfy the exemption's conditions with respect to all of its assets under management.[9] In contrast, an investment adviser with a principal office and place of business outside of the United States (i.e., a "non-U.S. adviser") would need to count only those private fund assets managed from a place of business in the United States toward the $150 million asset limit for purposes of the Private Fund Adviser Exemption.

Under the proposed rules, both U.S. advisers and non-U.S. advisers would be required to determine the amount of their respective private fund assets on a quarterly basis by reference to Form ADV, under which the SEC proposes a uniform method of calculating private fund assets under management for purposes of the Private Fund Adviser Exemption. In the event that an investment adviser subsequently becomes ineligible to rely on the Private Fund Adviser Exemption due to an increase in the value of its private fund assets in excess of $150 million, the investment adviser will have one calendar quarter within which to register with the SEC.

Conclusion

In light of the repeal of the private adviser exemption, the Venture Capital Exemption and the Private Fund Adviser Exemption represent important developments for venture capital funds and their management teams. The proposed rules outlined above are subject to public comment until the date 45 days after their publication in the Federal Register, which we expect will happen soon. Following its review of any comments offered during this period, the SEC will adopt its final rules for the Venture Capital Exemption and Private Fund Adviser Exemption, which may differ from these proposed rules. The comment process represents an important time for venture capital funds and their management teams to work with counsel to weigh in on matters of concern to them.

[1] Please see “Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers,” SEC Release No. IA-3111 (Nov. 19, 2010).

[2] Exempt advisers may also be required to register on Form ADV with one or more state securities authorities. Please see “Rules Implementing Amendments to the Investment Advisers Act of 1940,” SEC Release No. IA-3110 (Nov. 19, 2010).

[3] The proposed rules define “qualifying portfolio companies” as any company that (i) is not publicly traded, (ii) does not incur leverage in connection with the private fund’s investment, (iii) uses the capital provided by the private fund for operating or business expansion purposes rather than to buy out other investors, and (iv) is not itself a fund (i.e., is an operating company). Under the proposed definition, a qualifying portfolio company could not be publicly traded nor could it control, be controlled by or be under common control with a publicly traded company at the time of the investment by the private fund. However, a venture capital fund could continue to hold the securities of a qualifying portfolio company that subsequently becomes publicly traded. With respect to leverage, the proposed rules provide that a qualifying portfolio company may not borrow in connection with the private fund’s investment, but may incur debt in the ordinary course of its business (e.g., to finance inventory or capital equipment, manage cash flows, and meet payroll obligations). Finally, under the proposed rules, a qualifying portfolio company need not be a U.S.-based company.

[4] The SEC proposes to use the definition of “equity securities” in section 3(a)(11) of the Securities Exchange Act of 1934 and rule 3a11-1 thereunder, which definitions include any stock or similar security, any security future on any such security, any security convertible, with or without consideration, into such a security, any warrant or right to subscribe to or purchase such a security, certificate of interest, or participation in any profit-sharing agreement, limited partnership interest, interest in a joint venture, 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.

[5] In contrast, private funds that seek to satisfy the Department of Labor’s requirements to be deemed a venture capital operating company must obtain contractual management rights as to portfolio companies consisting of at least 50% of the value of the private fund’s portfolio.

[6] The grandfathering provision under the proposed rules requires only that the sale of securities be completed by July 21, 2011; the private fund need not make any capital calls prior to this date.

[7] The proposed rules define qualifying private funds as any private fund that is not registered under section 8 of the 1940 Act and has not elected to be treated as a business development company pursuant to section 54 of the 1940 Act.

[8] Under the proposed rules, an investment adviser’s principal office and place of business would be determined by identifying the location where the investment adviser controls or has the ultimate responsibility for the management of its private fund assets.

[9] Even if a U.S. adviser has offices outside of the United States, all of its private fund assets will be deemed to be under management in the United States for purposes of the Private Fund Adviser Exemption.