Cooley

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On Friday, November 19, 2010, the Securities and Exchange Commission (the "SEC") published a much anticipated set of proposed rules (the "Proposed Rules") setting forth its attempt to define what constitutes a "venture capital fund" for purposes of a new exemption from registration under the Investment Advisers Act of 1940, as amended (the "Advisers Act").

This *Alert* discusses the SEC's proposed "venture capital fund" definition as well as its potential impact on venture capital and other private funds.

Background

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Prior to the Dodd-Frank Act, many venture capital and private equity fund managers avoided registration under the Advisers Act by relying on the "private investment adviser" exemption which exempted firms that (i) had fewer than fifteen (15) clients over the course of the preceding twelve (12) months and (ii) neither had held themselves out generally to the public as an investment adviser nor acted as an investment adviser to any investment company registered under the Investment Company Act of 1940 (the "40 Act").

Title IV of the Dodd-Frank Act, the "Private Fund Investment Advisers Registration Act of 2010" (the "Private Fund Act"), replaced the private investment adviser exemption with new, more narrow exemptions, including an exemption for private fund managers that provide advice *solely* to one or more "venture capital funds" (the "VC Exemption"). The Private Fund Act charged the SEC with the responsibility of providing a definition of what would constitute a "venture capital fund" for purposes of the VC Exemption. After several months of soliciting comments from various professionals, firms and associations working in or with the investment fund industry regarding the proper scope and nature of the "venture capital fund" definition, the SEC has now proffered Proposed Rules and an accompanying release providing background on such definition (the "Exemption Release").

Venture capital fund exemption

New proposed Section 203(l)-1(a) of the Advisers Act would define a "venture capital fund" as any private fund[1] that meets *all* of the following criteria:

- The fund represents itself as a venture capital fund to investors
- The fund owns *solely* equity securities[2] of private companies[3] and cash, cash equivalents and certain U.S. treasuries
- None of the portfolio companies of the fund: (i) issue debt obligations (directly or indirectly) in connection with the fund's investment in such company; (ii) redeem, exchange or repurchase any securities of the company or distribute to existing security holders cash or other company assets in connection with the fund's investment in such company; or (iii) are themselves a private fund or other pooled investment vehicle
- At least eighty percent (80%) of the equity securities of *each* portfolio company of the fund were acquired by the fund *directly* from the portfolio company
- The fund and/or its managers: (i) *offer* to provide significant guidance regarding the management, operations or business objectives and policies of each portfolio company (and, if accepted actually provides such guidance) or (ii) *control*[4] each portfolio company
- The fund does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of fifteen percent (15%) of the fund's committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than one hundred twenty (120) calendar days
- The fund does not offer its investors redemption, withdrawal or other similar liquidity rights except in extraordinary circumstances[5]

- The fund is neither registered under the 40 Act nor has elected to be treated as a "business development company"

New reporting rules applicable even to exempt venture capital funds

Even if an adviser is able to avoid registration under the Advisers Act by qualifying under the VC Exemption, the Proposed Rules provide that it will nonetheless be required to comply with new reporting, recordkeeping and other compliance requirements proposed under the Private Fund Act applicable to both registered and exempt advisers.[6]

Grandfather rules

New proposed Section 203(l)-1(b) of the Advisers Act would include within the definition of "venture capital fund" any private fund that: (i) represented to its investors at the time of offering that it was a venture capital fund; (ii) closed on the commitments of one or more unaffiliated investors prior to December 31, 2010; and (iii) has held its final closing on or before July 21, 2011.

Accordingly, any firm presently managing one or more funds that have already held their final closings, and if each of those funds was originally represented as a venture capital fund at the time of fundraising, then such firm could rely on the VC Exemption even if one or more of those existing funds might not meet all of the requirements outlined above. For firms in the process of currently raising one or more venture capital funds, given the requirement noted above that a first closing of an unaffiliated investor must occur before December 31, 2010 in order to qualify such fund(s) for the grandfather rule, consideration should be given to holding such a closing before December 31, 2010, if practicable.[7]

Comment period

The SEC will now accept comments regarding the matters covered in the Exemption Release, including its proposed definition of "venture capital fund". Comments must be delivered on or before the forty-fifth (45th) day following the date the proposed rules are published in the Federal Register.

Recommendations

Given the importance of the Proposed Rules to the venture capital community at large, and the immediate reaction of many firms to certain aspects of the VC Exemption,[8] we expect the comment process, with respect to the Proposed Rules, to be very active and are hopeful that the SEC will see fit to make at least some corresponding revisions.

The SEC has voiced a strong preference for quickly finalizing the Proposed Rules after the comment process so that no matter what form such provisions ultimately take, advisers have adequate time to get appropriately prepared for registration under the Advisers Act (or if already registered, revise any applicable filings or compliance obligations as necessary) and/or understand and comply with the new recordkeeping, reporting and other compliance requirements applicable to advisers exempt from such registration (whether based on the VC Exemption or otherwise). Accordingly, we recommend that fund managers begin reviewing the Proposed Rules and Exemption Release as soon as possible to assess the likelihood of whether they will need to register under the Advisers Act, and, at a minimum, familiarize themselves with the obligations and contours of the new recordkeeping, reporting and other compliance requirements applicable to exempt fund managers as a matter of initial compliance readiness.

We will issue a more detailed release on the final rules once published (expected to be in early 2011) and generally keep you up to date on any other important developments in the interim. Should you have any immediate questions, comments or concerns regarding the matters discussed above, please contact any of your Cooley team members.

Notes

1 "Private Funds" generally include investment funds and other pooled investment vehicles that are excluded from the definition of "investment company" under the 40 Act by reason of Section 3(c)(1) or 3(c)(7) of such Act.

2 Delineation of permitted investments as only being in "equity securities" would altogether limit the ability of a fund that wanted to both qualify for the VC Exemption yet still also be able to invest in debt securities of or otherwise loan money to one of its portfolio companies. For many venture capital firms, such activities are often a key component of their overall investment strategy, including the ability to utilize bridge financings. The SEC proposes to borrow the definition of "equity securities" for purposes of the VC Exemption from similar definitions contained in Section 3(a)(11) of the Securities Exchange Act of 1934 and Rule 3a11-1 thereunder, which are broadly drafted (and the SEC has acknowledged would include many forms of typical venture capital bridge financing, if appropriately structured), yet may not include all forms of non-equity investing some venture firms pursue.

3 The Proposed Rules state that in order for a fund to be considered a "venture capital fund" for purposes of the VC Exemption, it must invest only in "qualifying portfolio companies." Among certain other requirements necessary for a portfolio company of a fund to be considered a "qualifying portfolio company" (generally noted in the third bullet of the "Venture Capital Fund Exemption" section contained herein), such company must not have been publicly traded *at any time the fund invested in* such company (nor may such company control or be controlled by or under common control with another company, directly or indirectly, that is publicly traded at such time). The practical outcome of such language is that a fund may continue to hold securities of a publicly traded company and still meet the definition of a "venture capital fund" if such securities were originally purchased when the company was private, but all other forms of investing in publicly traded securities (e.g., PIPEs transactions, open market purchases of public securities, etc.) would disqualify such fund from eligibility to be treated as a "venture capital fund" for purposes of the VC Exemption.

4 Under Section 202(a)(12) of the Advisers Act, the term "control" is broadly defined to mean "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company."

5 While the Proposed Rules themselves do not define what would constitute "extraordinary circumstances," the Exemption Release does provide helpful guideposts to the kind of events the SEC would likely consider as warranting certain redemption, withdrawal or other liquidity rights for investors without jeopardizing a fund's status as a "venture capital fund" under the VC Exemption. More specifically, the SEC acknowledges in the Exemption Release that venture capital funds typically only provide withdrawal rights under certain "foreseeable but unexpected circumstances," such as a change in the tax laws or regulatory rules applicable to an investor that makes continued investment in the fund impractical, burdensome or illegal (e.g., in the case of an ERISA violation where there is a strong likelihood that the assets of the fund would be treated as "plan assets" of an ERISA Partner therein for purposes of ERISA). Thus, any fund that permits its investors to redeem their interests or withdraw from the fund on a more regular and periodic basis at the pure discretion of the investor free of any prerequisite or precondition for a causal tax or regulatory issue or burden for such redemption or withdrawal will not likely be eligible to be treated as "venture capital fund" for purposes of the VC Exemption.

6 In a separate release issued on Friday, November 19, 2010 and the proposed rules published therewith (collectively, the "Implementing Release"), the SEC set forth the specific reporting requirements that will apply to advisers meeting certain of the newly created exemptions from registration under the Advisers Act (including the VC Exemption). More specifically, advisers falling under the VC Exemption ("VC Exempt Advisers") will be required to submit, and to periodically update, reports to the SEC by completing seven items on a "to be revised" version of Form ADV (which will now serve as both a reporting and registration form). New proposed Section 204-4 of the Advisers Act would require VC Exempt Advisers to complete the following items in Part 1A of the revised Form ADV: Items 1 (Identifying Information), 2.C (Other Business Activities), 7 (Financial Industry Affiliations and Private Fund Reporting), 10 (Control Persons), 11 (Disclosure Information) and corresponding sections of Schedules A, B, C and D. VC Exempt Advisers would not be required to complete and file with the SEC the other items in Part 1A or prepare a client brochure (Part 2). The disclosures made in the revised Form ADV noted above would be publicly available on the SEC website and the initial filing of the relevant portions of the Form ADV noted above would be due no later than August 20, 2011. A separate release regarding certain new proposed recordkeeping requirements for VC Exempt Advisers (as well as certain related SEC examination rights) will be released by the SEC in the near future. Please contact any of your Cooley team members regarding any questions, comments or concerns you may have regarding the Implementing Release.

7 We note that because the Proposed Rules (including the grandfather provision contained therein) are not in final form, such provisions are fully subject to change, which is an important matter to understand and risk to account for by any fund manager planning to structure its closing process around the grandfathering rules as currently proposed.

8 For example, a fund seeking to qualify as a "venture capital fund" under the VC Exemption would (i) be prohibited from participating in PIPEs transactions or other acquisitions of public securities, (ii) be prohibited from investing in funds and pooled investment vehicles (e.g., seed funds, certain joint ventures, etc.), (iii) be severely limited in its ability (if not prohibited) to invest in any form of debt securities of or make any loans to its portfolio companies, (iv) have its borrowing activity (including guarantees) capped at 15% of its committed capital and be limited only to certain non-recurring, short-term obligations, (v) be strictly limited in the types of idle funds investments permitted, and (vi) potentially have very limited flexibility to operate in certain funding models that involve periodic withdrawal rights that might be characterized as redemptions.

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Key Contacts

Mark Tanoury Palo Alto	tanourymp@cooley.com +1 650 843 5016
John Dado San Francisco	dadoja@cooley.com +1 650 843 5126

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