

Sponsored Article

SEC Proposes Rules For VC Exemption To Registration Under Investment Advisers Act

By Howard Beber, Partner, and Michael Suppappola, Senior Associate, Proskauer Rose LLP

As many advisers to private funds prepare for registration with the Securities and Exchange Commission under the Investment Advisers Act of 1940, the SEC recently proposed rules regarding an exemption from SEC registration for advisers that provide advice solely to venture capital funds. Specifically, the proposed rules set forth the definition of a venture capital fund and provide a grandfathering exemption for existing venture capital funds.

Defining A Venture Capital Fund

The proposed rules would define a venture capital fund as a "private fund" (i.e., generally a pooled investment vehicle that is not a registered investment company pursuant to exemptions set forth in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940) that meets the following six criteria:

1. The fund represents to its investors and potential investors that it is a venture capital fund. Accordingly, venture capital firms hoping to rely on the exemption should pay careful attention to how they are describing their funds and investment strategies in marketing materials and regulatory filings.
2. The fund owns solely (a) cash or cash equivalents, (b) certain U.S. Treasury securities and (c) equity securities of qualifying portfolio companies (QPCs) and at least 80% of the equity securities of each QPC owned by the fund were acquired directly from such QPC (rather than acquired from an existing shareholder).

Equity securities would include common stock and securities convertible into common stock, and therefore would include convertible preferred stock issued by most venture-backed companies as well as convertible notes typically issued in bridge financings.

A QPC would include any company that (i) is not publicly traded or a control affiliate of a publicly traded company at the time of any investment by the private fund; (ii) does not borrow or issue debt obligations, redeem or repurchase securities of the company or distribute company assets in connection with the private fund's investment; and (iii) is not a "private fund." Notably, the definition of QPC would preclude a venture capital fund from making PIPE investments.

3. The fund, directly or through its adviser, either (a) controls each QPC or (b) has an arrangement whereby the fund or its adviser offers to provide significant guidance and counsel concerning the management, operations or business objectives and policies of the company.

4. The fund does not borrow or otherwise incur indebtedness (including guarantees) in excess of 15% of the fund's aggregate capital commitments, and any such borrowing or indebtedness has a non-renewable term of no longer than 120 days.
5. The fund does not permit its investors to withdraw or redeem their fund interests, except in extraordinary circumstances.
6. The fund is a "private fund" as described above.

The proposed rules would also grandfather within the definition of a venture capital fund any private fund that (i) represented to investors and potential investors at the time of the offering of interests in such fund that it was a venture capital fund; (ii) issues interests in the fund to one or more third-party investors prior to Dec. 31, 2010; and (iii) does not issue any additional interests after July 21, 2011. Funds that satisfy these three criteria would not be required to satisfy the six criteria described above. Accordingly, a venture capital adviser hoping to rely on the exemption should ensure that fund-raising is completed by July 21, 2011 for any existing funds not in compliance with the criteria described above.

Disclosure, Recordkeeping Requirements And SEC Examinations

The proposed rules also contemplate new disclosure and recordkeeping requirements for venture advisers that have historically applied only to registered advisers. Additionally, the SEC stated that it has authority to conduct examinations with respect to the books and records of venture advisers. The scope and nature of any such examinations is unclear. The SEC has also indicated that the recordkeeping requirements for venture advisers will be addressed in a subsequent SEC release.

Regarding SEC reporting, the proposed rules would require venture advisers to make periodic filings via Form ADV Part 1. Specifically, venture advisers would be required to file an initial Form ADV Part 1 no later than Aug. 20, 2011. Venture advisers would only be required to respond to a limited number of Form ADV inquiries, including detailed information about a venture adviser's ownership structure and comprehensive information about each venture capital fund it advises. All information filed with the SEC via Form ADV Part 1 would need to be updated at least annually and would be publicly available via the SEC's website.

The comment period for the proposed rules expires on Jan. 24, 2011, after which the SEC is expected to release final rules. ■