Proskauer

SEC Issues Interpretive Guidance on the Venture Capital Fund Adviser Exemption

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On December 2, 2013, the SEC's Division of Investment Management issued a new "Guidance Update" that provides some important interpretive guidance on the exemption from registration under the Investment Advisers act of 1940 (the "Advisers Act") for certain venture capital fund advisers (the "VC Exemption"). In particular, the Guidance Update clarifies that certain structures and practices common in the venture capital fund industry will not impact the availability of the VC Exemption.

By way of background, the VC Exemption exempts from registration under the Advisers Act investment advisers whose business is limited solely to advising one or more venture capital funds ("VC Advisers"). [1] To qualify as a "venture capital fund" for this purpose, Advisers Act Rule 203(l)-1 provides that a fund must be a private fund[2] that, among other things, holds not more than 20% of its aggregate called capital contributions and uncalled capital commitments (excluding cash and cash equivalents) in non-qualifying investments (the "Qualifying Investment Requirement").[3] A "qualifying investment" is generally defined as an equity security acquired directly from a qualifying portfolio company. A "qualifying portfolio company" is defined generally as a private operating company (*i.e.,* a company that is not itself an investment company or private fund) that is not publicly traded in the U.S or elsewhere (nor a control affiliate of a company that is publicly traded).[4]

The Guidance Update focuses on various scenarios in which compliance with the Qualifying Investment Requirement could be called into question under a literal reading of Rule 203(l)-1. In particular:

1. Intermediary Holding Companies. Venture capital funds frequently invest in portfolio companies through intermediary holding companies, which do not technically qualify as qualifying portfolio companies because they are not operating companies. Although Rule 203(l)1 expressly permits venture capital funds to ignore wholly owned intermediary holding companies for purposes of

complying with the Qualifying Investment Requirement, the Rule does not address situations in which multiple funds invest in a portfolio company through a single intermediary holding company. In the Guidance Update, the Staff states that it will not object if a VC Adviser disregards an intermediary holding company that is wholly owned by multiple venture capital funds for purposes of complying with the VC Exemption, so long as all of the funds are advised by the same VC Adviser (or its related persons).

2. Feeder Funds. Venture capital funds frequently set up feeder funds to address varying tax, legal or regulatory concerns of their investors. Feeder funds (referred to as "AIVs" in the Guidance Update) invest all of their assets in a master fund, which is not a qualifying portfolio company because it is not an operating company. AIVs do not, therefore, technically comply with the Qualifying Investment Requirement. In the Guidance Update, the Staff states that it would not object to VC Advisers disregarding AIVs for purposes of complying with the VC Exemption, provided that (i) the AIV is formed solely to address investors' tax, legal or regulatory concerns, and (ii) such AIV is not intended to circumvent the VC Exemption's general limitation on investing in other investment vehicles.[5]

3. Warehousing Transactions. At times, VC Advisers will warehouse investments in qualifying portfolio companies for a venture capital fund that is in the fundraising process by investing in the portfolio company itself and then transferring the investment over to the fund at or shortly after the fund's initial closing. Such a transaction could be considered a nonqualifying investment under the VC Exemption, because the securities in question have not been acquired by the venture capital fund directly from the qualifying portfolio company. In the Guidance Update, the Staff states that it would not object to warehoused investments being treated as qualifying investments for purposes of complying with the VC Exemption, provided that (i) such investment is initially acquired by the VC Adviser (or a person wholly owned and controlled by the VC Adviser) directly from the qualifying portfolio company solely for the purpose of acquiring the investment for a venture capital fund that is actively in the process of raising capital, and (ii) the terms of the warehoused investment are fully disclosed to prospective investors prior to their committing to invest in the fund.[6] The Guidance Update does not, however, specifically address situations where an existing venture capital fund warehouses investments for a successor venture capital fund during the successor fund's fundraising process.

4. Side Funds. Similarly, the Staff also took the interpretive position in the Guidance Update that it would not object to any transfers between a venture capital fund and any side funds established to invest in parallel with the venture capital fund after the venture capital fund is closed, provided that (i) such transfer takes place within 12 months of the final closing of the venture capital fund, and (ii) the potential for this type of transfer is fully disclosed in the governing documents for both the main fund and the side fund.[7]

5. Liquidating Trusts. Finally, the Staff took the interpretive position in the Guidance Update that it would not object to the transfer of investments in qualifying portfolio companies from a venture capital fund to a liquidating trust for the purposes of winding up the affairs of the venture capital fund.

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A complete copy of the Guidance Update can be found on the SEC's Website at http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-13.pdf. Clients of Proskauer should contact their assigned lawyer to discuss any implications that the new Guidance Update may have on their businesses.

[1] Although exempt from registration under the Advisers Act, investment advisers that rely on the VC Exemption are still required to file annual reports on Form ADV with the SEC as "exempt reporting advisers."

[2] A "private fund" is defined as a fund that relies on the exemptions from the definition of investment company provided in either section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940.

[3] The other conditions that a "venture capital fund" must meet are:(i) the fund must represent to investors that it pursues a venture capital strategy; (ii) the fund may not offer investors redemption rights (except in extraordinary circumstances); (iii) the fund may not borrow or otherwise incur leverage in excess of 15% of the fund's aggregate called capital contributions and uncalled capital commitments (and then, only on a short-term basis); and (iv) the fund may not be a registered investment company or a business development company under the 1940 Act.

[4] Qualifying portfolio companies also are prohibited from borrowing or issuing debt securities in connection with the venture capital fund's investment in such company and distributing the proceeds of such borrowing or issuance in exchange for the venture capital fund's investment.

[5] Notwithstanding this helpful guidance with respect to feeder funds, the Guidance Update does not address whether other types of alternative investment vehicles (such as alternative investment vehicles formed for tax, legal or regulatory purposes that make one or more nonqualifying investments in lieu of the venture capital fund) would similarly be disregarded.

[6] In a footnote to the Guidance Update, the Staff advised that it would typically expect to see the following items of information disclosed to prospective investors in connection with a fund's contemplated warehousing transactions: (i) the name of the portfolio company; (ii) the cost at which the warehoused investment was acquired; (iii) how the price at which the fund will acquire the warehoused investment will be determined (*e.g.,* fair market value or cost plus interest) and whether such price accounts for any adverse event that may have occurred; and (iv) any potential conflicts of interests arising as a result of the warehoused transaction. The Staff also cautioned VC Advisers to consider their fiduciary obligations under the antifraud provisions of the Advisers Act (including Section 206(3) and Rule 206(4)-8).

[7] As with the Staff's guidance with respect to warehoused transactions, the Staff cautioned VC Advisers to consider their fiduciary obligations under the antifraud provisions of the Advisers Act when engaging in transactions between a venture capital fund and any related side funds.

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