A PRACTICAL GUIDE TO VENTURE CAPITAL FUNDS: REGISTRATION EXEMPTION FOR "VENTURE CAPITAL FUND" ADVISERS FROM ADVISERS ACT

By Bettina Eckerle | July 30, 2011

Beginning July 21, 2011, by SEC Release. No IA-3222, issued on June 22, 2011, the SEC introduced a new exemption from registration under the Investment Advisers Act (the "Advisers Act") that is available to advisers that manage only venture capital funds. A single adviser that manages both venture capital funds and other types of funds cannot qualify for this exemption. The new rules provide a detailed definition of "venture capital fund" for this purpose, although a less restrictive definition applies to existing funds that qualify for a "grandfather rule."

> The SEC tried -- successfully -- to capture the characteristics of venture capital funds, as many commenters agreed, while providing enough flexibility for deviations from the typical model.

Definition of "Venture Capital Fund." A "venture capital fund" is required to have all of the following attributes:

- Represents itself as pursuing a venture capital strategy;
- Makes qualifying investments;
- Limits leverage;
- Offers no redemption rights except in extraordinary circumstances;
- Has not registered under the Investment Company Act (the "1940 Act") or elected to be a business development company; and
- Is a "private fund."

- **Venture Capital Strategy**. The fund must represent itself to its investors and potential investors as pursuing a venture capital strategy. The determination of whether a venture capital fund makes such a representation is based on all of the statements made by the fund to its investors and prospective investors, including in marketing materials and subscription agreements. It is not necessary for the fund to include the term "venture capital"

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in its name. It may even be possible for a venture capital fund to properly represent itself as pursuing a venture capital strategy without ever using the term, although this seems to create unnecessary risk. The new rules do not expressly state that a venture capital fund must represent that it pursues a venture capital strategy to the exclusion of all other strategies.

I would advise funds seeking to qualify as venture capital funds to affirmatively use the term "venture capital strategy" in their marketing materials and governing agreements. The fund should also not identify itself as multi-strategy fund (i.e. venture capital being one of several investment strategies along, with for example a hedge fund strategy).

- **Qualifying Investments**. As of the time immediately after a fund's acquisition of any asset other than qualifying investments and short-term holdings, no more than 20% of the fund's capital contributions and uncalled committed capital may consist of assets other than qualifying investments or short-term holdings. This 20% "basket" is intended to allow a fund flexibility to engage in a variety of investments and activities. The release expressly contemplates that, within this basket, qualifying funds may make investments more typically associated with hedge, private equity or other types of funds, as well as other investments that do not meet the strict "qualifying investment" tests for any reason.

  - **Types of Qualifying Investments**. In general, a "qualifying investment" is defined to mean: (1) an equity security issued by a qualifying portfolio company that has been acquired by the fund directly from such portfolio company; (2) an equity security issued by a qualifying portfolio company in exchange for a directly acquired security previously issued by the qualifying portfolio company; and (3) an equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, or a predecessor, and that is acquired by the fund in exchange for a security spelled out in (1) and (2).

    - **Equity Security**. The term "equity security" is defined very broadly (by reference to the definition under Section 3(a)(11) of the Securities Exchange Act of 1934) and includes: "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 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."

      The inclusion of preorganization certificates and subscriptions may be particularly helpful to seed-stage funds that acquire interests in companies which have not yet completed their formation process

      The term "equity security" includes many typical forms of hedges (e.g., puts, calls and straddles relating to common or preferred stock). However, it also appears to exclude many typical forms of hedges (e.g., currency and interest rate swaps). As with other types of non-qualifying investments, a qualifying fund may enter into non-qualifying hedges within its 20% basket.

- **Maximum of 20% of Capital in Non-Qualifying Investments**. For this purpose, a fund's capital is deemed to consist of capital contributed to the fund plus uncalled capital commitments. This is not identical to the total capital commitments made by the fund's investors. The rule appears to exclude capital that has been called, but not yet been contributed, for example in the scenario where there is a pending capital call or a capital call default. Moreover, uncalled capital commitments may be counted only if they are bona fide commitments, i.e., there must be no understanding that such commitments will not be called and the adviser must have a reasonable belief that investors will be able to satisfy calls when issued.

The new rules require care in performing the calculation and may create difficult questions regarding the capital commitments of investors that the adviser believes to be in financial distress or otherwise subject to burdens (such as regulatory limitations) that may interfere with satisfaction of capital calls.

- **Valuation of Non-Qualifying Assets**. Non-qualifying assets may be valued at cost or fair value; however, once chosen, the fund must apply the same method to all non-qualifying assets in a consistent manner throughout the fund's term. Alternating between valuation methodologies is not permitted. Because the fair value of most fund assets is difficult to determine, we anticipate that most funds will elect to value non-qualifying assets at cost.

- **Immediately After Acquisition of an Asset**. The 20% test is applied only immediately after the fund's acquisition of an asset other than a qualifying investment or short-term holding. Under this approach, a fund need only calculate the 20% limit each time it acquires a non-qualifying investment. Thus, a subsequent change in the value of non-qualifying assets or the amount of the fund's capital will not result in failure to satisfy the 20% test.

It is quite possible that a fund may, at multiple times during its term, hold a portfolio that consists substantially or even entirely of non-qualifying assets without violating the 20% test. For example, a fund's initial investment at the start of its term or last remaining investment at the conclusion of its term might be a non-qualifying asset. In either such case, the portfolio would, at a specific point in time, consist entirely of non-qualifying assets. So long as those assets do not exceed 20% of the fund's capital at the time of acquisition of any non-qualifying asset, the 20% test is satisfied.

- **Qualifying Portfolio Company**. In general, a "qualifying portfolio company" is any company that: (1) at the time of any fund investment, is not publicly traded and does not have a control relationship with a publicly traded company; (2) does not borrow and distribute the proceeds of such borrowing to the fund in exchange for the fund's investment; and (3) is not itself a fund, i.e. is an operating company.

  - **Not Publicly Traded**. In this context, publicly traded means subject to the reporting requirements of the Securities Exchange Act of 1934 or having a security listed or traded on any exchange or organized market operating in a foreign jurisdiction.

This rule may be problematic for funds that invest outside the U.S., where many companies become publicly traded while still in early stages of development.

Because the publicly traded status of a portfolio company is determined only at the time of the fund's investment, a portfolio company

will not cease to qualify when the portfolio company conducts an IPO, although any new investment in the company post-IPO would need to be included in the 20% test. Securities issued after a conversion or exercise of qualifying investments that consist of convertible debt, options or warrants that were acquired by the fund pre-IPO would probably not be counted as new investment for this purpose.

- **Leverage**. The portfolio company must not borrow or issue debt obligations in connection with the fund's investment in the company and distribute to the fund the proceeds of the borrowing in exchange for the fund's investment. This is quite narrow.

A qualifying portfolio company may borrow for general business purposes and, it appears, may even borrow to redeem securities held by third parties. Moreover, the release states that subsequent distributions by the portfolio company to the fund solely in respect of the fund's status as an investor would not be subject to the limitation.

- **Operating Company**. A qualifying portfolio company generally must be an operating company, rather than another private fund, commodity pool, or other investment company. A fund may disregard a wholly owned intermediate holding company formed solely for tax, legal or regulatory reasons.

  In general, venture capital funds cannot themselves be qualifying portfolio companies, with the result that venture capital fund of funds do not qualify for the venture capital exemption.

- **Directly Acquired and Recap Securities**. Except in the context of a merger and acquisition transaction, a qualifying investment generally must be acquired directly from the issuer, which means that equity securities acquired on a secondary basis cannot be qualifying investments.

The release seemingly provides flexibility to portfolio companies to issue new securities to a fund and simultaneously redeem out existing shareholders in connection with a fund's investment without counting it towards the 20% non-qualifying basket.

In the context of a recapitalization, the release acknowledges that recap securities can be qualifying investments when the fund, along with other existing security holders, accepts newly issued equity securities in exchange for previously issued equity securities.

- **M&A Securities**. As stated in the release, the SEC has provided venture capital advisers with flexibility to participate in mergers and acquisitions without running afoul of the requirement that a security be directly acquired from the issuer.

  While these provisions would appear to cover most common mergers and acquisition transactions involving acquirors that are not themselves qualifying portfolio companies, some types of transactions are not clearly addressed, for example an acquisition that is structured as an asset purchase. It would seem appropriate to provide the same treatment for those types of transactions, although additional guidance may be required to achieve clarity on this point.

- **Limitation on Leverage of Fund**. In general, the aggregate amount of a fund's borrowing, issued debt obligations, guarantees of third-party obligations and other leverage must not exceed 15%

of the fund's capital, defined as capital contributions and uncalled capital commitments, and any such obligations must have a non-renewable term of 120 days or less. The 120-day limit does not apply to the fund's guarantee of a qualifying portfolio company's obligations, up to the amount of the fund's investment in the portfolio company.

- **When and How Tested**. Although not clarified in the release, it appears that the 15% limit should be determined by reference to the amount of borrowing, obligations, guarantees and other leverage in effect at a specific time, rather than on a cumulative basis over the fund's term. The release leaves a number of other open questions. It is unclear whether the 15% test is applied only immediately after each new borrowing is entered into, and whether accrued interest must be taken into account.

- **Changes to Common Borrowing Arrangements**. Many venture capital funds establish lines of credit to bridge capital calls and provide for other short-term capital needs.

  Such lines of credit may still be used, but a number of previously common terms generally should be changed. For example, such lines of credit generally should no longer provide for terms longer than 120 days or for automatic renewals.

  It also would be advisable to carefully review loan agreements for cross-guarantee provisions. Many loan agreements require cross-guarantees by parallel or affiliated funds. Such cross-guarantees generally would count toward the 15% limit.

- **Other Considerations**. Venture capital funds often engage in activities that may be deemed leverage for purposes of the new rules. For example, a fund's General Partner may defer receipt of management fees in order to allow the fund to make additional investments. Unless properly structured, such a deferral may be deemed a borrowing or other use of leverage that counts toward the 15% limit.

- **No Redemption Rights**. A venture capital fund must not issue securities that grant investors a right to withdraw, redeem or require the repurchase of such securities except under extra-ordinary circumstances. However, investors may be entitled to receive pro rata distributions from the fund. This rule is based upon a principal distinction between venture capital funds and hedge funds who typically grant broad redemption rights. While the release does not define when "extraordinary circumstances" exist, it appears that the rule is based on an intention to allow redemption rights of the type historically common in the venture capital industry.

- **No Registration/Election Under the Investment Company Act**. The fund must not be registered as an investment company under the 1940 Act, i.e., the fund must not be a mutual fund, and not have elected to be a business development company under the 1940 Act.

- **"Private Fund" Status; Special Rule**. The fund must be a "private fund." For purposes of this exemption, the venture capital fund determination is limited to limited partnerships or other pooled investment vehicles excluded from the definition of "investment company" under the 1940 Act. For this purpose, under the SEC's prior interpretations of the 1940 Act, a fund generally can be a private fund only if it avails itself of U.S. jurisdictional means when fundraising or engaging in certain other activities, but the venture capital exemption in the new Advisers Act rules includes an additional special rule.

  Under this special rule, a non-U.S. fund that does not use U.S. jurisdictional means to conduct an offering, and in

particular, does not offer interests to U.S. persons, could be considered a "private fund" and, assuming it otherwise met the venture capital fund definition, could fall under the venture capital fund exemption under the new rule.

- **Grandfathering Provision**. Under the rule, a fund is a venture capital fund, even if it does not satisfy the general definition, if it has all of the following attributes.

Funds that satisfy the requirements grandfathering criteria would not be required to satisfy the other elements of the definition of venture capital fund outlined above.

  - **Venture Capital Strategy**. A grandfathered venture capital fund must have represented at the time of the offering to its investors that it was pursuing a venture capital strategy. In general, the considerations applicable to this requirement are identical to those described above regarding the general definition.

  - **Initial Closing**. A grandfathered fund must have sold securities, prior to December 31, 2010, to one or more investors that are unrelated to the fund's adviser.

  - **Final Closing**. A grandfathered fund must not issue securities to any person, including by means of accepting a capital commitments, after July 21, 2011.

The release confirms that calling capital after July 21, 2011 for commitments existing on July 21, 2011 will not violate this requirement.

  - **Private Fund**. A grandfathered fund must be a "private fund," in the same manner as under the general venture capital definition.

- **Reporting Requirement**. Advisers relying on the venture capital fund exemption remain subject to certain SEC reporting requirements and oversight including a requirement to file a limited subset of the items in Part 1A of Form ADV. See for more details "The Practical Guide: Exempt Reporting Adviser Reporting Requirements."

A venture capital fund that intends to rely on the venture capital fund exemption would need to go through the analysis and confirm that it can rely on the exemption in its annual updating amendment to Form ADV. The deadline for filing the initial subset of Part 1A is March 30, 2012.

For more details, see: http://www.sec.gov/rules/final/ia-3222.pdf

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