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# Venture Capital & Emerging Companies

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# SEC Adopts Dodd-Frank Act Exemption and New Reporting Requirements For VC Fund Advisers

Authors: Hale T. Boggs | Michael E. Wong | Janson L. Mao | Rory Donald

**On June 22, 2011, the SEC adopted new rules to implement Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which, among other things, created a new exemption from the registration requirements of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), for investment advisers to venture capital funds. The new rules define the term "venture capital fund," set forth new reporting requirements for venture capital fund advisers and extend the compliance deadline to March 30, 2012. The new rules can be found in SEC Release No. IA-3221 and SEC Release No. IA-3222 (the "Releases").**

### New Exemption For Venture Capital Fund Advisers

*Definition*. The Dodd-Frank Act exempts investment advisers that advise solely venture capital funds from the registration requirements of the Advisers Act. New rule 203(l)-1 provides a definition of "venture capital fund" that is broader than originally proposed by the SEC. The rule generally defines a venture capital fund as a private fund that:

1. other than short-term holdings, invests only in qualifying investments (generally equity securities in qualifying portfolio companies that are directly acquired by the fund and

certain equity securities exchanged for such directly acquired securities), subject to a basket of 20% of the fund's capital commitments for investments in non-qualifying investments;

2. does not borrow or otherwise incur leverage in excess of 15% of the fund's capital commitments or for a term longer than 120 calendar days (subject to an exception for certain guarantees of a qualifying portfolio company's obligations);

3. does not offer its investors redemption or similar liquidity rights except in extraordinary circumstances;

4. represents to investors and potential investors that it pursues a venture capital strategy; and

5. is not registered under the Investment Company Act of 1940, as amended, and has not elected to be treated as a business development company.

*20% Basket*. The SEC had originally proposed restricting investments by venture capital funds to direct equity investments in qualifying portfolio companies, cash and cash equivalents, and U.S. Treasuries. Allowing for greater investment flexibility under the final rule, the 20% basket permits a venture capital fund to invest up to 20% of its capital commitments in non-qualifying investments, such as public company securities, debt instruments and securities purchased in secondary transactions. To determine compliance with the 20% basket, the fund may value a non-qualifying investment at either historical cost or fair value, as long as the same method is applied consistently to all investments. The 20% limit is measured only at the time the fund acquires a non-qualifying investment so that the fund need not dispose of a non-qualifying investment simply because of a change in the value of that investment.

*Grandfathering Provision*. The final rule contains a grandfathering provision that exempts certain preexisting venture capital funds from conforming with the requirements of the new definition. Under the final rule, a "venture capital fund" includes any private fund that (i) has represented to investors and potential investors at the time the fund offered its securities that it pursues a venture capital strategy; (ii) has sold securities to investors prior to December 31, 2010; and (iii) does not sell any securities to, including accepting any capital commitments from, any person after July 21, 2011.

**New Reporting and Recordkeeping Requirements For Venture Capital Fund Advisers**

Even though venture capital fund advisers are exempt from the registration requirements of the Advisers Act, the SEC has adopted rules that subject venture capital fund advisers to new reporting obligations. The final rules require venture capital fund advisers to file reports electronically with the SEC using the same Form ADV Part 1A as registered investment advisers. Venture capital fund advisers, however, are required to respond only to a portion of the items on Form ADV Part 1A, including:

1. basic identifying information about the adviser;

2. the exemption on which the adviser is relying to report, rather than register, with the SEC;

3. information about the adviser's private funds and the funds' service providers;

4. information about the other business activities and financial industry affiliations of the adviser and its related persons;

5. information about the adviser's control persons; and

6. any disciplinary history of the advisor and its advisory affiliates.

All information reported to the SEC on Form ADV by a venture capital fund adviser will be made publicly available on the SEC's website. As discussed below, the deadline by which venture capital fund advisers must file their first reports on Form ADV has been extended to March 30, 2012.

The adoption of these new reporting requirements was not by unanimous vote. Two commissioners dissented on the basis that the reporting requirements may effectively eliminate the distinction between registered and unregistered advisers and subject the venture capital community to burdensome compliance obligations that may be harmful to capital formation. Chairman Mary Shapiro directed the SEC staff to reconsider the information collected from venture capital fund advisers after assessment of the first year's filings.

Venture capital fund advisers will also be subject to recordkeeping rules that the SEC expects to adopt in the future. The SEC is authorized to require venture capital fund advisers to keep such records as the SEC deems necessary or appropriate to protect investors. Although the SEC has not provided specific guidance as to the future recordkeeping requirements, it is likely that venture capital fund advisers will be required to maintain copies of their Form ADVs and certain books and records related to their advisory business and private funds. It is also possible that venture capital fund advisers will be subject to limited SEC examinations to ensure compliance with reporting and recordkeeping requirements, although the SEC has indicated that it does not intend to conduct routine examinations of venture capital fund advisers. The SEC will, however, conduct cause examinations where there are indications of wrongdoing prompted by tips, complaints or referrals.

**Extension of Compliance Deadline**

Prior to enactment of the Dodd-Frank Act, most advisers to venture capital funds and other private funds had been exempt from the registration requirements of the Advisers Act by virtue of the “Private Adviser Exemption” for investment advisers having fewer than 15 clients. The Dodd-Frank Act eliminated the Private Adviser Exemption effective July 21, 2011. As a result, advisers relying on the Private Adviser Exemption would be required to register with the SEC by July 21, 2011, unless they qualify for a different exemption. In the Releases, the SEC extended certain registration and reporting compliance deadlines to March 30, 2012. As a result, investment advisers that currently rely on the Private Adviser Exemption and do not qualify for a different exemption will not be required to register with the SEC, and venture capital fund advisers and other exempt reporting advisers will not be required to comply with the new reporting obligations, until March 30, 2012.

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