News Bulletin

November 29, 2010

Give Risk a Chance

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") contains numerous mandates for rulemaking and studies by the Securities and Exchange Commission (the "SEC") and other governmental agencies. Accordingly, many of the implications of the Dodd-Frank Act have yet to be realized.

One mandate relates to venture capital funds. Consistent with past legislative and regulatory efforts to increase federal oversight over hedge funds and their advisers, the Dodd-Frank Act repealed Section 203(b)(3) of the Investment Advisers Act of 1940 (the "Advisers Act"). Prior to its repeal, Section 203(b)(3) provided an exemption from the Advisers Act for certain fund advisers, generally based on the number of clients of the adviser and whether the adviser holds itself out to the public as an investment adviser. Advisers that meet the conditions of Section 203(b)(3) are exempt from the onerous recordkeeping requirements of the Advisers Act and are not subject to examination by the SEC staff. Section 203(b)(3) is commonly referred to as the private advisers' exemption.

Advisers of privately held hedge funds, private equity funds, venture capital funds and other similar funds historically have relied on the private advisers' exemption to avoid being subject to the Advisers Act. Since the credit crisis of 2008, there have been a number of legislative and regulatory efforts to regulate hedge funds; these efforts are intended to address any systemic risk posed by hedge funds or other unregistered funds that form part of the "shadow banking system." The need for increased regulation of hedge funds is a matter that is subject to reasonable debate. However, efforts to regulate hedge funds have threatened to affect other types of funds, funds that do not pose the same systemic risks. The repeal of the private advisers' exemption will result in many private funds becoming subject to the Advisers Act.

The Dodd-Frank Act includes, among other exemptions, a provision that exempts an investment adviser that solely advises venture capital funds from registration under the Advisers Act. The provision directs the SEC to define the term "venture capital fund" within one year of the enactment of the Dodd-Frank Act.

The Release

On November 19, 2010, the SEC issued a Preliminary Rule Release (the "Release") relating to proposed rules that, among other things, provide a definition of the term "venture capital funds." The Release is posted at the following web address: http://sec.gov/rules/proposed/2010/ia-3111.pdf. According to the Release, the Dodd-Frank Act includes an exemption for advisers of private venture capital funds because such funds invest in early-stage companies and are generally not leveraged and, thus, do not contribute to systemic risk. The SEC stated that it considered the Congressional intent when drafting the proposed definition. As proposed in the Release, a venture capital fund is a private fund that:

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- invests in equity securities of private companies in order to provide operating and business expansion capital (such private companies are "qualifying portfolio companies," which are discussed below) and at least 80% of each company's securities owned by the fund were acquired directly from the qualifying portfolio company;
- directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio companies;
- does not borrow or otherwise incur leverage (other than limited short-term borrowing);
- does not offer its investors redemption or other similar liquidity rights, except in extraordinary circumstances;
- represents itself as a venture capital fund to investors; and
- is not registered under the Investment Company Act of 1940 and has not elected to be treated as a business development company.

The proposed rules contain a grandfather clause that causes the term "venture capital fund" to include any private fund that: (i) represented to investors and potential investors at the time the fund offered its securities that it is a venture capital fund; (ii) has sold securities to one or more investors prior to December 31, 2010; and (iii) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011.

The rules define a qualifying portfolio company as any company that:

- is not publicly traded;
- does not incur leverage in connection with the investment by the private fund;
- uses the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors; and
- is not itself a fund but is an operating company.

The SEC specifically noted in the Release that venture capital funds may hold cash, cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less.

Considering the onerous nature of the reporting requirements of the Advisers Act, one should expect that, upon the effectiveness of the final rules, venture capital advisers will generally ensure that the funds they manage qualify as venture capital funds under the rules. Accordingly, funds formed after the rules become effective will face limitations that change the way many venture capitalists operate and will cause new funds to face disadvantages that are not faced by those funds that are grandfathered. In addition, early-stage issuers may voluntarily refrain from taking advantage of certain financing opportunities so as to make sure they are not precluded from being deemed qualifying portfolio companies which may adversely affect their future financing efforts. An early-stage issuer that allows itself to fall outside the parameters of a qualifying portfolio company may find that its pool of potential financing sources has contracted if venture capital funds are not able to invest in the company without becoming subject to the registration requirements of the Advisers Act.

The SEC has requested comments regarding most of these issues in the Release. Accordingly, the final rules may be considerably different. Parties that are interested in providing comments to the SEC should consider limitations on the nature of investments and the identities of the issuers. The following is a summary of certain provisions of the rules.

Definition of Venture Capital Fund

To be deemed a venture capital fund under the proposed rules, a fund may invest only in equity securities. The Release notes that the SEC intends to use the definition of equity security set forth in Section 3(a)(11) of the Securities Exchange Act of 1934. This is a broad definition which includes preferred stock and other securities exercisable for or convertible into common stock. Venture capital funds should maintain the flexibility to structure their investments to include many forms of hybrid instruments that include debt characteristics. Industry participants that are monitoring the comment phase of the proposed rules should consider the flexibility they need to invest in different investment structures.

With respect to any qualified portfolio company in which a venture capital fund has acquired securities, at least 80% of the securities must have been acquired directly from the company. This provision prevents funds from purchasing significant amounts of securities from a company's existing shareholders. A substantial majority of venture capital transactions involve direct or primary issuances. However, from time to time, venture-backed companies may have shareholders that want to, or need to, dispose of their interests. In addition, many preferred shareholders may have redemption rights or similar rights with respect to their holdings. Having existing shareholders, or even new shareholders, acquire the interests of such holders may be beneficial to the issuer, its other shareholders and the shareholders that want to dispose of their interests.

The Release provides that a venture capital fund must provide significant management assistance to, or control, a portfolio company in which it invests. This provision creates significant limitations. While many venture capitalists provide significant managerial resources to their portfolio companies, they are not always able to do so, even if they so desire. In many instances, a venture capital firm may find management best suited to manage their respective companies and decide to remain passive with respect to management unless and until needed. In addition, many venture capital investments are made with a syndicate of venture capitalists. Query how multiple funds can each provide significant managerial assistance to the same portfolio company effectively, if at all. Depending on the final guidance regarding the level of involvement that would be deemed significant managerial assistance under the rules, venture capital advisers may not be able to comply with this provision, even after using their best efforts.

Under the proposed rules, venture capital funds may not borrow or otherwise incur leverage, other than short-term borrowing under the rules nor may venture capital funds offer their investors redemption or other similar liquidity rights, except in extraordinary circumstances. Such provisions are designed to protect the market from systemic risk. Considering the size of the venture capital market and the type of investments made, an over-leveraged venture capital fund should not pose systemic risk. In addition, due to the illiquid nature of most venture capital investments, redemption, if allowed under the funds' governing documents, will not cause the public market trading that is often caused by high amounts of hedge fund redemption. Rather, a venture capital fund's investors should control the ability of the fund to incur leverage or affect redemption.

Definition of Qualifying Portfolio Company and the Effect on the Capital Markets

The definition of qualifying portfolio company excludes publicly traded companies. Although a significant portion of venture capital investments are made with privately held companies, certain venture capitalists invest in publicly traded companies. Venture capitalists are regular participants in PIPEs and other private transactions with small, publicly traded companies. The lower valuations over the last two years in the U.S. public markets have increased public company investments by venture capitalists. Prohibiting venture capital funds from participating in public investments would adversely affect the business models of many funds. It would also adversely affect the pool of capital available for small cap companies, thereby making it more expensive for small cap companies to seek financing and providing an advantage for grandfathered funds. In the Release, the SEC sought comments regarding whether venture capital funds should be allowed to invest in publicly traded companies. It is reasonable to assume that some limits may be set in this regard. However, completely prohibiting public investments by venture capital funds is too restrictive. One suggestion by the SEC in the

Release is to allow venture capital funds to make follow-on investments in portfolio companies after they have gone public. This is not sufficient. Venture capital funds should not be limited to public investments in which they already have interests.

A company that is deemed a qualifying portfolio company under the proposed rules may not incur leverage in connection with an investment from a private fund. Additional guidance is necessary to determine what is meant by "in connection with an investment" for purposes of the rules. Industry participants should be concerned whether this provision would affect a portfolio company's ability to take advantage of available venture lending without losing its qualified portfolio company status. If a portfolio company has access to venture lending, its ability to access the loans should not be hindered by the rules.

The proposed rules also prohibit a qualifying portfolio company from using capital provided from a fund to buy out other investors. This provision will affect a company's ability to honor existing redemption obligations owed to preferred shareholders. The provision will also hinder a company's ability to use venture capital funding to buy out shareholders that need or want to dispose of their interests in the company.

Last, a qualified portfolio company must be an operating company. This provision may restrict the ability of venture capital funds from structuring their investments through other entities. Funds will need to limit their transaction structures to ensure that they invest directly in the portfolio company, not through an investment vehicle or through other funds.

Foreign Private Advisers

The proposed rules have implications for foreign advisers. The proposed rules exempt foreign private advisers from registration under the Advisers Act. For purposes of the proposed rules, a foreign private adviser is any investment adviser that has no place of business in the United States, has fewer than 15 clients in the United States and investors in the United States in private funds advised by the adviser, and less than $25 million in aggregate assets under management from such clients and investors.

The methodology of counting the number of clients will contain many of the same provisions regarding related parties of both natural persons and entities and will have certain provisions to avoid double counting. Similarly, there will be instructions regarding the calculation of assets under management.

Many foreign venture capital funds have U.S. clients and will need to consider the proposed rules to the same extent as their counterparts in the United States. On the other hand, foreign funds that meet the conditions of the foreign private adviser exemption will be able to invest in companies which U.S. venture capital funds may have to avoid. This should lead to lower valuations for companies that are not qualified portfolio companies. In a financing market that is truly global, this exemption may provide foreign funds with an advantage over U.S. venture capital funds.

Form ADV

The proposed rules do not completely exempt advisers from regulatory supervision. Private advisers that are exempt under the rules, which are referred to as exempt reporting advisers in the Release, will be required to file Form ADVs as do other advisers; however, the exempt advisers will not be required to provide all of the information that is generally required to be disclosed by registered advisers. In addition, the SEC will have the statutory authority to examine the books and records of advisers relying on the exemptions described in the Release. The contents of the Form ADVs to be filed by exemption reporting advisers are proposed to include identifying information, SEC reporting information, form of organization, other business activities, financial industry affiliations and private fund reporting, control persons and disclosure information. The Form ADVs will need to be filed through the Investment Adviser Registration Depository (IARD) and will be available on the SEC's website. More information about the filing requirements may be found in a second proposed rule release posted

by the SEC at the same time it posted the Release. The second release is posted at http://sec.gov/rules/proposed/2010/ia-3110.pdf. The SEC anticipated promulgating additional rules regarding recordkeeping by exempt private advisers.

Conclusion

There are numerous implications for U.S. and foreign private venture capital advisers in the rules proposed in the Release. The final rules will have a direct effect on the companies that look to venture capital funds for financing as well as other industry participants. Industry participants and companies that rely on, or expect to rely on, venture capitalists for financing should consider providing comments to the SEC. Comments are due on or before the date that is 45 days after publication of the Release in the Federal Register and instructions for the submission of comments may be found at the beginning of the Release.

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