SEC Proposals for Venture Capital and Private Fund Advisers

David H. Pankey
Anitra T. Cassas
Clifford A. Cutchins IV
Christopher S. Nesbit
H. Ramsey White III
Steven J. Keeler
Fred T. Isaf
Robert G. Marks
Mark A. Kromkowski
Geoffrey C. Cockrell
W. Tom Donaldson III

www.mcguirewoods.com

McGUIREWOODS

McGuireWoods news is intended to provide information of general interest to the public and is not intended to offer legal advice about specific situations or problems. McGuireWoods does not intend to create an attorney-client relationship by offering this information, and anyone's review of the information shall not be deemed to create such a relationship. You should consult a lawyer if you have a legal matter requiring attention.

Copyright © 2011 by McGuireWoods LLP. All rights reserved.

SEC PROPOSALS FOR VENTURE CAPITAL AND PRIVATE FUND ADVISERS

Effective July 21, 2011, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) eliminates the exemption from federal investment adviser registration that is currently available to advisers with fewer than 15 clients. In the past, a large number of advisers to venture capital and private equity funds have relied on this exemption, and accordingly, are not currently registered with the SEC.

In place of this exemption, Dodd-Frank includes several new exemptions, including an exemption for advisers solely to venture capital funds (Venture Capital Exemption), and an exemption for advisers solely to private funds with assets under management (AUM) in the United States of less than $150 million (150 Million Exemption). On Nov. 19, 2010, the SEC issued two releases proposing how these new exemptions will work, as well as covering several other matters. See Release Nos. IA-3110 and IA-3111.

"In many cases, current unregistered advisers and those contemplating a new fund will have to go back to the drawing board or register with the SEC. "

OVERVIEW OF THE SEC PROPOSALS

Venture Capital Exemption

Dodd-Frank contains an exemption for advisers that only manage venture capital funds, and directs the SEC to define a venture capital fund. The SEC has proposed that an adviser managing only funds meeting certain requirements would be eligible for the Venture Capital Exemption. Funds satisfying the following requirements would be "venture capital funds" under the proposed rule:

- The fund invests in equity securities of qualifying private companies (explained further below) to provide operating and business expansion capital;
- At least 80% of the securities of each company owned by the fund need to be acquired by the fund directly from the portfolio company, rather than from investors in the portfolio company;
- The fund directly or through its advisers, controls or offers or provides significant managerial assistance to each qualifying portfolio company;
- The fund does not borrow or otherwise rely on leverage (other than limited short term borrowing); and
- The fund does not offer its investors redemption or other similar liquidity rights, except in extraordinary circumstances.

In addition, a venture capital fund needs to represent itself to be a venture capital fund (rather than a hedge fund, private equity fund or multistrategy fund), and cannot be registered under the Investment Company Act of 1940, as amended (ICA), or be a business development company (BDC).

The proposed rule includes a grandfather clause under which existing funds that do not meet all these requirements can still qualify as venture capital funds, if they have represented themselves as venture capital funds, accepted outside investments before the end of 2010 and accept no new investments after July 21, 2011.

An adviser can manage an unlimited number of venture capital funds with unlimited AUM under this exemption.

150 Million Exemption

The SEC has also proposed the terms of a new 150 Million Exemption. An adviser can manage any number of private funds under this exemption, so long as the only advisory clients are private funds and the aggregate AUM in the United States of those private funds is less than $150 million.

For this purpose, a private fund is an investment vehicle that is exempt from registration under the ICA pursuant to either the C1 exemption (fewer than 100 beneficial owners) or the C7 exemption (a qualified purchaser fund). If an adviser has even one advisory client that is not a private fund, including any managed account or individual client, it would not qualify for this exemption regardless of the amount of AUM.

The SEC is proposing a "uniform" method of calculating AUM for these advisers (and for several other purposes), which involves the use of fair value (rather than cost) and includes uncalled capital commitments. AUM will need to be calculated quarterly, and if AUM increases above $150 million, this exemption will no longer be available. In this case, an adviser will have three months to register, if the adviser has complied with its reporting requirements.

Reporting Requirements for These Exempt Advisers

Dodd-Frank provides that the SEC can require advisers who are exempt from federal investment adviser registration under either of the Venture Capital or the 150 Million Exemptions to file reports. The SEC's proposal includes the form, content and manner of filing of these reports. These reports are proposed to be contained in a portion of Form ADV, and would be filed electronically on the system currently used by registered investment advisers. As a result, the information in those reports will be publicly available.

The required material includes data about the adviser and extensive information about funds managed. The first report would need to be filed by Aug. 20, 2011.

MAKING COMMENTS ON THE SEC PROPOSALS

The proposed exemptions raise a number of practical, logistical and interpretive issues. In many cases, current unregistered advisers and those contemplating a new fund will have to go back to the drawing board or register with the SEC.

Advisers to venture capital and private equity firms should consider commenting on these proposals. The SEC is actively soliciting industry perspectives on a number of issues, and comments may have an impact on the final rule.

The proposed rule is based upon a rather narrow business model. The proposed Venture Capital Exemption generally will not cover advisers to private equity funds, consistent with the legislative history. Comments on this aspect of the proposal are not likely to have much impact. However, as explained below, there are a number of significant practical implications of the rule as proposed. These include the impact of the proposed rule on bridge financings and unconventional fund structures. In addition, the proposed rule is fairly restrictive in terms of the investment of unused cash, and contains ambiguous provisions relating to the ability of a portfolio company to redeem its shares after an investment by a venture capital fund. The proposed Venture Capital Exemption also contains several other provisions that may create uncertainty, such as the extent of involvement with a portfolio company that is required to satisfy the "management assistance" item.

There are also a number of issues relating to the proposed 150 Million Exemption, including lack of guidance as to the valuation of illiquid positions.

The proposed releases do not provide guidance on whether compliance with the Venture Capital Exemption or the 150 Million Exemption will be based solely on the activities of the manager in question, or will also take into account activities of affiliates of that manager. In addition, the proposed reporting provisions for advisers relying on either exemption will result in a substantial amount of information becoming publicly available. It is inevitable that this information will be published by the financial media.

Comments on these proposals are due on or before Jan. 24, 2011. You may wish to consider commenting on these proposals so that your perspective is considered by the SEC during the formulation of the final rule.

ACTION ITEMS

Between now and the issuance of final rules, you should prepare for the coming regulatory changes. Consider the following actions:

√ ***Venture Capital Exemption*** – If you manage an existing venture capital fund, you should determine if this fund qualifies under the grandfather clause. You should also

determine if it is feasible going forward for your new funds to operate as venture capital funds under the proposed rule.

√ ***150 Million Exemption*** – You should determine if your AUM is less than $150 million, as calculated in accordance with the proposed rule, and determine if each of your advisory clients will qualify as a private fund.

√ ***New Reporting Obligations*** – If you will qualify under either the new Venture Capital Exemption or the new 150 Million Exemption, you should prepare to comply with the exempt advisers reporting requirements. These requirements will involve disclosing extensive information about private funds managed, as explained further below.

√ ***Restructuring of Operations*** – If you do not currently qualify for the new Venture Capital Exemption or the new 150 Million Exemption, you may wish to consider the possibility of restructuring your operations so that you do qualify.

√ ***Registration*** – If you do not qualify for these exemptions, and no other exemptions are available, you should determine if you are eligible for federal registration and begin preparing for registration. In general, federal registration is available for advisers with AUM of $100 million or more. Otherwise, state registration generally will be required.

√ ***State Regulatory Issues*** – The proposed Venture Capital and 150 Million Exemptions do not provide exemptions for state purposes. Accordingly, advisers will need to check applicable state law and monitor state law for changes in response to Dodd-Frank.

We anticipate that a number of states will revise their investment adviser provisions in response to the new regulatory structure resulting from Dodd-Frank. The North American Securities Administrators Association (NASAA) has already proposed a model rule in response to the exemptions discussed in this article. The proposed NASAA Model Rule would provide a state exemption for C7 funds where the adviser does not have a "disqualifying" regulatory history, and files the report described above with the state as well as with the SEC. The comment period for this rule also ends Jan. 24, 2011.

DETAILS ON VENTURE CAPITAL EXEMPTION

The Venture Capital Exemption will be available to advisers that only manage "venture capital funds." The SEC proposes to define a venture capital fund as a company that invests in equity securities of qualifying portfolio companies (QPCs) and cash or cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or fewer. For this purpose, an equity security is contrasted with a debt security, which is not a qualifying investment, unless convertible into equity.

Qualifying Portfolio Company

A QPC is any company that:

- Is not publicly traded. At the time of each investment by the fund, the QPC needs to be a private company and cannot be controlled by a public company. A venture capital fund may continue to own securities of a QPC that goes public after the investment by the fund.
- Does not incur leverage in connection with investment by the fund. Any financing or loan to a portfolio company provided by or as a condition of a contractual obligation with a fund or the adviser to a fund would be considered to be "in connection with" an investment by the fund. This provision does not restrict borrowing by the QPC from other sources.
- Uses the investment by the fund for operating or expansion purposes. Capital provided by a venture capital fund cannot be used to buy out existing investors or be distributed to existing investors. As a result, the investment of a venture capital fund cannot be used to redeem existing investors or to fund payments to existing investors in a recapitalization. The proposed rule does provide a limited ability to buy out investors in a QPC in that up to 20% of a venture capital fund's position in a QPC can be the result of purchases from existing investors in the QPC.
- Is an operating company as opposed to an investment vehicle. This requirement prohibits investment in a fund or securitized asset vehicle.

An offshore company can be a QPC. In other words, in order to be a QPC, the entity does not need to be a domestic company, or doing business in the United States.

Management Assistance

A venture capital fund (directly or through its adviser) needs to either control the QPC or have an arrangement to provide management assistance to the QPC.

The proposing release states that managerial assistance would generally take the form of active involvement in the business, operations or management of the portfolio company, or less active forms of control, such as board representation or similar voting rights.

Each venture capital fund participating in an investment needs to satisfy this requirement. It is not clear how this requirement will work as a practical matter in the case of an investment in the same QPC by several venture capital funds.

Limited Buy-outs

At least 80% of the securities of each QPC need to be purchased directly from the QPC. Put another way, up to 20% of the securities of a QPC can be purchased from

investors in the QPC. The SEC stated that this provision was intended to allow a venture capital fund to provide liquidity to the founder of a QPC or an angel investor.

Limitation on Leverage

A venture capital fund cannot incur debt, issue guarantees, or otherwise use leverage in excess of 15% of capital and uncalled capital commitments, and any borrowing, guarantee or leverage needs to be for a non-renewable term of no more than 120 days. This 15% limit is calculated on an aggregate basis and not deal by deal.

Limited Redemption Rights

Interests in a venture capital fund cannot be redeemable at the option of the holder except in extraordinary circumstances, which the SEC expects generally to be beyond the control of the investor, such as a change in law.

Represents Itself to be a Venture Capital Fund

A venture capital fund needs to represent to investors and potential investors that it is a venture capital fund, as opposed to a hedge fund, private equity fund or multistrategy fund. A venture capital fund can satisfy this requirement by describing its investment strategy as venture capital investing or as a fund that is managed in compliance with the SEC's proposed rule.

Not a Mutual Fund or BDC

A venture capital fund cannot be registered under the ICA or be a BDC.

Venture Capital Exemption Issues

The proposed venture capital exemption raises a number of issues. For example, the narrow definition of a venture capital fund will exclude advisers to private equity funds. As a result, advisers to those funds will either need to qualify for another exemption or register (if eligible). In general, federal registration is required if you have $100 million or more of AUM, and otherwise state registration is required. There are a few situations where federal registration is required for an adviser with less than $100 million, such as where the adviser is not subject to state registration and examination requirements or would be required to register in 15 or more states.

In addition, there are a number of practical issues with the proposed venture capital fund rule.

Only private companies will qualify as QPCs. As a result, the proposal does not allow investments in PIPES. And, of course, an investment immediately before an initial public offering could cause a problem under the proposed definition.

Only equity securities of QPCs can be held. Accordingly, the proposal limits the possible investments to equity and debt which is convertible to equity. This aspect of the proposal is particularly restrictive in terms of bridge financings.

Follow on investments are subject to the same restrictions.

The SEC's proposal requires that funds invested in a QPC be used for operations or expansion, rather than to buy out investors in the QPC. This requirement could cause ambiguity concerning the authority of a QPC to buyout investors in a QPC after an infusion of capital from a venture capital fund. Establishing that funds for redemptions did not come from a cash infusion might be difficult as a practical matter.

The proposing release is very clear that a fund of funds structure will not qualify under the Venture Capital Exemption. However, the proposing release does not explicitly indicate whether certain unconventional fund structures (such as where individual investors can opt out of specific investments) will qualify.

In addition, there is some ambiguity concerning exactly what will be considered to be "management assistance," as required by the rule.

Grandfather Provision

The proposed rule includes a grandfather clause that allows certain existing funds to be considered to be venture capital funds, even if they do not meet all the criteria outlined above so long as the following criteria are satisfied:

- The fund represented to investors and potential investors at the time the fund offered its securities that it was a venture capital fund;
- The fund has sold securities to one or more outside investors before Dec. 31, 2010; and
- The fund does not sell any securities, including accepting additional capital commitments, from any person after July 21, 2011.

Under the SEC's proposal, funds representing that they are hedge funds or private equity funds would not qualify under this provision.

An adviser that only advises venture capital funds meeting the proposed definition could also advise venture capital funds that fit under the grandfather provision.

DETAILS ON 150 MILLION EXEMPTION

Dodd-Frank directs the SEC to adopt an exemption from the federal adviser registration provisions for any investment adviser solely to private funds that in the aggregate have less than $150 million in AUM in the United States.

Advises Solely Private Funds

This new exemption will be available to an adviser that only manages private funds. For this purpose, private fund means a C1 (fewer than 100 beneficial owners) or a C7 (qualified purchaser fund). All advisory clients need to be private funds within this meaning. In the case of an adviser based in the United States, all advisory clients are counted. If a U.S. adviser has even one client that is not a private fund, that adviser will not qualify for this exemption. Also, an adviser can manage any number of private funds, so long as the aggregate AUM is less than $150 million.

Calculation of AUM

Under the proposed rule, a U.S, adviser would need to aggregate the value of all assets of private funds it manages to determine if the adviser is under the $150 million threshold. This calculation would need to be done on a quarterly basis in a manner set forth in Form ADV.

The SEC is proposing changes to Form ADV which are intended to provide a "uniform" method for calculating AUM for this purpose and for other regulatory purposes. This method is based on the value (rather than cost) of assets managed, as well as proprietary assets, assets managed without compensation and uncalled capital commitments. Liabilities cannot be deducted. If the governing documents of the fund provide for a method of determining fair value, that method can be used, so long as it is consistent with the requirements of the proposed rule. The proposing release does not provide guidance on the valuation of illiquid investments and does not require that fair value be determined in accordance with GAAP.

A sub-adviser would only need to count that portion of the assets of the private fund as to which it has responsibility.

Transition Rule

The SEC is proposing that an adviser that becomes ineligible to use the 150 Million Exemption because of an increase in AUM will have three months to register. This grace period will only be available if the adviser is in compliance with its reporting obligations, discussed below.

150 Million Exemption Issues

While the new definition of AUM is intended to be uniform, it does not provide any guidance in the area of valuation of illiquid investment positions. A portion of, and in many cases a substantial portion of, private fund investments can be expected to be in illiquid securities. Significant variation in the approach to the valuation of these securities may take place after implementation begins.

EXEMPT REPORTING ADVISER

Advisers qualifying for the new Venture Capital Exemption or the new 150 Million Exemption will need to file reports concerning the funds they manage. These reports will need to be made on a specified portion of Form ADV, and filed electronically on the system currently used by registered advisers. There will be a fee associated with the filing. In addition, the information contained in these reports will be publicly available.

The detailed information required to be reported includes information about the adviser, as well as the private funds managed.

Adviser Information. The information required with respect to the adviser includes the following:

- Name, contact information, form of organization and ownership of the adviser (including identification of owners).
- Other activities of the adviser or its affiliates that might cause conflicts of interest.
- Disciplinary history of the adviser.

Fund Information. The report will also need to contain comprehensive information about the private funds managed, including the following:

- Identifying information
- Organizational information
- Master or feeder
- Fund of funds
- ICA exemption
- 33 Act exemption
- Gross and net asset values
- Investment strategy, type of fund
- Breakdown of assets and liabilities under the GAAP (Level 1, 2 and 3) classification system
- Fund investors – number and type
- Minimum investment amount
- Characteristics of the fund that may give rise to conflicts of interest in terms of the fiduciary duty of the adviser
- Identification and information concerning five service providers:
  - Auditor – whether it is independent, registered with and inspected by the PCAOB and distributes audited statements to investors.
  - Prime broker – whether it is SEC-registered and acts as custodian for fund assets.
  - Custodians – whether they are related persons of the adviser.
  - Administrator – whether it prepares account statements and sends them to investors, and what percentage of fund assets it values.

o Marketers – whether they are related persons of the adviser, their SEC file number, and the address of any website they use to market the fund.

The SEC is proposing that a coding system can be used to avoid identifying the private fund by name. However, service providers will need to be named.
An exempt reporting adviser needs to provide the information specified as to funds it manages, but not as to funds managed by its affiliates.

Timing and Updating. The first report will need to be filed by Aug. 20, 2011. This information will need to be updated on an annual basis and amended more frequently in certain circumstances.

SEC EXAMINATIONS

Exempt reporting advisers are subject to examination by the SEC. An examination might be triggered by information contained in the new required filings, or as a result of other examinations or developments.

For additional information, please contact:

David H. Pankey
202.857.1716
dpankey@mcguirewoods.com

Anitra T. Cassas
804.775.4727
acassas@mcguirewoods.com