Proposed SEC Rules for Venture Capital Funds and Private Fund Advisers

December 13, 2010

On November 19, 2010, the Securities and Exchange Commission (the "SEC") proposed rules defining the term venture capital fund and implementing the new exemption from SEC registration for advisers to private funds introduced by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The new exemptions will become effective on July 21, 2011.

Dodd-Frank added a new Section 203(l) to the Investment Advisers Act of 1940, as amended (the "Advisers Act"), pursuant to which investment advisers who *only* advise venture capital funds are exempt from SEC registration. Pursuant to Section 203(m) added to the Advisers Act by Dodd-Frank, investment advisers who *only* advise private funds with assets under management of less than $150 million in the United Sates are exempt from SEC registration.

Venture Capital Funds

The proposed SEC Rule 203(l)-1 defines a venture capital fund as a private fund that meets *all* of the following six criteria.

1. The private fund must represent to existing and potential investors that it is a venture capital fund.

2. The private fund owns *solely* equity securities issued by one or more qualifying portfolio companies; and cash, certain cash equivalents, and U.S. Treasuries with a remaining maturity of 60 days or less.

3. The investment adviser or the fund must either (i) have an arrangement with each qualifying portfolio company pursuant to which the fund or the investment adviser offers to provide significant guidance and counsel concerning the management operations or business objectives and policies of the portfolio company, or (ii) control the portfolio company.

4. The private fund does not borrow or issue debt obligations, provide guarantees or otherwise incurs leverage in excess of 15 percent of the fund's aggregate capital contributions and uncalled committed capital, and such borrowing, debt obligations, guarantees, or leverage is for a non-renewable term of no longer than 120 calendar days.

5. The private fund only issues securities that do not provide a holder with any right to withdraw, redeem or require the repurchase of securities, except in extraordinary circumstances.

6. The private fund is not registered under Section 8 of the Investment Company Act of 1940, as amended (the "Investment Company Act"), and has not elected to be treated as a business development company pursuant to Section 54 of the Investment Company Act.

While the proposed rules defines the term venture capital fund broadly insofar as it does not impose any limitations as to the size of the funds or companies in which a venture capital may invest, it does exclude a number of private equity funds from the definition. See *"Ineligible Private Equity Funds"* below

Grandfathered Private Equity Funds

Existing venture capital funds benefit from a special grandfathering rule. Pursuant to this rule, any existing private fund qualifies as a venture capital fund if such fund (1) has represented to investors and potential investors *at the time of the of offering of securities* that it is a venture capital fund, (2) has sold securities

to one or more investors that are not related persons of the investment adviser, and (3) does not sell any securities to, or accept committed capital from, investors after July 21, 2011.

Qualifying Portfolio Companies

A qualifying portfolio company of a venture capital fund is a company that:

1. At the time of investment by the venture capital fund (i) is not reporting companies under Sections 13 or 15(d) of the Securities Exchange Act of 1934, as amended, or has a security that is listed or traded on *any* exchange or organized market in a foreign jurisdiction; or (ii) controls or is controlled by, or under common control with, another company whose securities are publicly traded;

2. Does not borrow or issue debt obligations, directly or indirectly, in connection with the venture capital fund's investment in such portfolio company;

3. Does not redeem, exchange or repurchase any of its securities, or distribute to pre-existing security holders cash or other company assets in connection with the venture capital fund's investment in the company; *and*

4. Is not an investment company, a private fund, or an issuer that would be an investment company but for the exception provided by SEC Rule 3a-7 under the Investment Company Act, or a commodity pool.

In addition to excluding certain types of private equity funds (such as buy-out funds, funds that invest in public companies, and funds of venture capital funds) from the definition of venture capital funds, the proposed definition of a qualifying portfolio company also has the practical effect of limiting certain types of investments that a venture capital fund may make. Namely, a venture capital fund could not invest in a company in which a publicly traded strategic investor has a controlling interest at the time of investment (e.g., a biotech company in which a publicly traded pharmaceutical company holds, directly or indirectly, a controlling interest).

Ineligible Private Equity Funds

The proposed rules make buy-out funds, hybrid private equity and hedge funds, and funds of venture funds or other private equity funds ineligible for the venture capital fund exemption. Likewise, advisers to funds investing in public companies (including those whose shares are only traded in the over-the-counter market) will not be able to rely on this exemption. Advisers to these funds may instead rely on the exemption for private fund advisers with assets under management of less than $150 million in the United States or, if they are located outside of the United States, on the exemption for private advisers (see *"Foreign Advisers Exemption"* below). Existing private funds may also qualify as venture capital funds pursuant to the grandfathering rule discussed above.

Advisers to Private Funds with Less than $150 Million in Assets under Management

U.S. Investment Advisers

An investment adviser with its principal office and place of business in the United States is exempt from SEC registration if the adviser acts solely as an investment adviser to one or more qualifying private funds and manages private fund assets of less than $150 million, irrespective of the location of these assets. In other words, domestic investment advisers must count private offshore funds without any U.S. investors towards the $150 million asset limit under the exemption.

Foreign Investment Advisers

An investment adviser with its principal office and place of business outside of the United States would be exempt from SEC registration if (1) the foreign investment adviser has no client that is a United States person except for one or more qualifying private funds, and (2) all assets managed by the adviser *from a place of business in the United States* are solely attributable to private fund assets with a total value of less than $150 million.

For purposes of defining the term "United States person" the SEC relies on the definition of a "U.S. person" under Regulation S, but treats discretionary accounts held by a non-U.S. securities dealer or professional fiduciary for the benefit of a U.S. person as a United States person if the dealer or professional fiduciary is related to the foreign investment adviser relying on the exception. A qualifying private fund is a private fund that is not registered under the Investment Company Act and has not elected to be treated as a business development company.

Accordingly, a foreign investment adviser would only have to count assets managed from within the United States towards the $150 million limit under the exemption and would remain eligible to rely on the private fund adviser exemption if it conducted advisory activities other than advising private funds from a place of business outside of the United States. However, if these activities include advisory services to U.S. clients or U.S. investors in private funds, presumably, the foreign investment advisor, would have to meet the conditions for the foreign private adviser exemption to escape SEC registration. See *"Foreign Private Adviser Exemption"* below.

Foreign Private Adviser Exemption

Instead of relying on the exemption from SEC registration for advisers to venture capital funds and private funds, foreign investment advisers to these funds may instead rely on the exemptions from Advisers Act registration provided for advisers to foreign private advisers. For a discussion of the proposed SEC rules for these advisers please refer to our client information "Foreign Investment Advisers: Traps for the Unwary in the Proposed SEC Rules."

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This summary is intended to provide general information only on the matters presented. It is not a comprehensive analysis of these matters and should not be relied upon as legal advice. If you have any questions about the matters covered in this publication, please contact:

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