Marlowe Legal LLC Advisors

Investment Advisers Act of 1940

Venture Capital and Private Fund Exemptions

SEC Provides Certain Private Fund Managers Limited Relief

Background

Investment managers of private funds (such as venture capital, private equity, real estate, and hedge funds)[1] ("Private Fund Managers") have been greatly concerned about the regulations in the Dodd-Frank Act requiring such managers to register with the SEC as investment advisers. In the past, Private Fund Managers were mostly exempt from investment adviser registration at both the federal and state levels. The Dodd-Frank Act eliminated the exemptions Private Fund Managers relied on previously and requires Private Fund Managers with assets under management of $150 million or more to register with the SEC as investment advisers, subject to certain exceptions which were left to the SEC to clarify.

Private Fund and Venture Capital Exemptions

On June 22, 2011, the SEC adopted final rules under the Investment Advisers Act of 1940, as amended (the "Advisers Act") to implement the provisions of the Dodd-Frank Act relating to investment advisers. These rules require most Private Fund Managers to register under the Advisers Act as investment advisers prior to March 30, 2012. The SEC also adopted two exemptions from the registration requirements:

(i) the "private fund adviser exemption," which exempts managers who advise only private funds[2] and whose assets under management are less than $150 million (measured annually) (the "Private Fund Exemption"); and

(ii) the "venture capital exemption," which exempts managers who manage only *venture capital funds* as the SEC has defined such term (the "Venture Capital Exemption"). This second exemption is of particular interest to the venture capital community (as well as the private equity and real estate communities) because it allows managers of *venture capital funds* to manage in excess of $150 million but remain exempt from registration and (most of) the requirements of the Advisers Act.

What is a "venture capital fund" (according to the SEC)?

Under the Venture Capital Exemption, a "venture capital fund" is a private fund that:

- Represents to investors and potential investors that it pursues a venture capital strategy;
- Invests at least 80% of its committed capital in "qualifying investments" (but may invest up to 20% in any other type of investment);
- Does not use leverage (including guarantees) in excess of 15% of the fund's committed capital; and
- Does not provide any redemption rights to investors (except in extraordinary circumstances).

"Qualifying investments" are equity investments (which include convertible securities) in *qualifying portfolio companies* or equity securities issued in exchange for such equity investments made in qualifying portfolio companies by such portfolio company or any successor. A "qualifying portfolio company" means any company (not funds or pools) that (i) is not an SEC reporting company or traded in the U.S. or abroad (nor controlled by any SEC reporting company or company traded in the U.S. or abroad) and (ii) does not issue debt in connection with the investment by the private fund and distribute the proceeds of such debt issuance to the private fund in exchange for the private fund investment (the SEC is excluding leveraged buyout funds from the *venture capital fund* definition).

The definition of venture capital fund did not change significantly from the proposed definition in November 2010, despite the SEC receiving over 70 comment letters on this definition alone. The biggest change in the final rules was allowing venture capital fund managers to invest up to 20% of their capital in non-qualifying investments. This will allow venture capital funds some flexibility to invest in what the SEC considers to be non-venture capital investments (such as bridge notes, leveraged transactions, IPO allocations, PIPEs, etc.) so long as the 20% limit is not exceeded. The 20% limit is measured at the time of each non-qualifying investment based on value (at either cost or fair market value, whichever has been used by the fund since inception) of all non-qualifying investments as compared to committed capital (including uncalled capital) of the fund.

Are Exempt Managers Really Exempt?

Managers who meet either the Venture Capital Exemption or the Private Fund Exemption ("Exempt Managers") will not have to register with the SEC and be subject to all of the rules, regulations and other requirements of the Advisers Act. However, the SEC did not let Exempt Managers entirely off the hook. Exempt Managers will still have file a Form-ADV with the SEC, which is the same form that non-exempt managers have to file, though Exempt Managers only have to fill out certain specified parts of the ADV. Exempt Managers will also have to pay a filing fee, be subject to certain recordkeeping requirements and be subject to SEC examination. Additionally, as was the case prior to Dodd-Frank, all investment managers, whether registered or not, are subject to the anti-fraud rules of the Advisers Act.

The Form-ADV filed by Exempt Managers will be available publicly (like all Form-ADVs) and disclose basic identification details (such as name, address, contact information, form of organization, and who controls the adviser), provide details regarding other business activities in which the adviser and its affiliates are engaged, require advisers to disclose the disciplinary history of the adviser and its employees, and require disclosure information regarding each private fund.

An additional concern to Exempt Managers is how state securities regulators will look at private fund managers that fall below the federal threshold or are otherwise exempt. Congress and the SEC delegated oversight of "mid-size advisors" (those with AUM between $25 and $100 million) to the states. Many state securities laws and regulations previously exempted managers of private funds by relying on the federal exemptions that the Dodd-Frank Act repealed. So it remains to be seen if private fund managers not required to register with the SEC, who in the past were also exempt at the state level, will now have to be registered with one or more states.

Conclusion

All Private Fund Managers will now have to assess where they fall in the spectrum of investment adviser registration rules (including at the state level) and whether they can avail themselves of either the Private Fund or Venture Capital Exemptions. Those that are not exempt will have to fully register, make necessary disclosures and deliveries to clients, put into place a full compliance program, name a chief compliance officer (CCO), and make themselves subject to routine SEC examinations. Even those federally exempt advisers will have to file a shorter version of Form ADV (and update annually), pay a fee, and be subject to possible SEC exams. Exempt Managers will also need to determine whether state registration will be required.

If you would like to review the SEC releases relating to these new investment adviser rules, you can access them under the Resources heading at www.marlowelegal.com/news.htm.

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About Marlowe Legal Advisors

Keith Marlowe, Esq. is the Founder and Managing Partner of Marlowe Legal Advisors, LLC, a corporate and securities boutique law firm based in suburban Philadelphia, PA. Marlowe Legal Advisors' clients range from start-up businesses to public companies and institutional investment clients. Marlowe Legal Advisors covers a wide range of corporate and securities matters. A portion of Marlowe Legal Advisors' practice is devoted to advising private funds (venture capital, private equity, real estate and hedge funds) on all aspects of their business including formation, offerings, securities issues, operations and compliance as well as assisting investment advisers with registration and compliance. More information on Marlowe Legal Advisors can be found at www.marlowelegal.com. You may also contact Keith Marlowe directly at keith@marlowelegal.com or at 215-690-1414.

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[1] Funds not registered under the Investment Company Act of 1940, as amended (the "40 Act"). Registered funds are typically mutual funds.
[2] Managers who manage private funds plus managed accounts my not use the Private Fund or the Venture Capital exemptions and therefore must determine whether they are required to otherwise register at the state or federal level.

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