Securities and Exchange Commission (SEC) Staff Issues Guidance on Exemption for Advisers to Venture Capital Funds

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Rule 203(l)-1 under the Advisers Act exempts from registration advisers to one or more venture capital funds. A venture capital fund is any private fund that: (i) represents to potential investors that it pursues a venture capital strategy; (ii) holds no more than 20% of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets that are not qualifying investments; (iii) does not borrow or otherwise incur leverage in excess of 15% of the fund's aggregate capital contributions and uncalled capital commitments; (iv) issues securities that provide a holder with redemption rights only in extraordinary circumstances; and (v) is not registered under the Investment Company Act and has not elected to be treated as a business development company. In response to certain inquiries, the Division of Investment Management provided guidance on whether certain advisers would be able to rely on the venture capital fund exemption.

Intermediate Holding Companies. Under Rule 203(l)-1, funds are required to invest at least 80% of their assets in qualifying investments, defined generally as an equity security issued by a qualifying portfolio company that has been acquired directly by the private fund from the qualifying portfolio company. Venture capital funds that hold their portfolio company investments through an intermediate holding company may disregard an intermediate holding company formed solely for tax, legal or regulatory reasons to hold the fund's investment in a qualifying portfolio company so long as such intermediate holding company is wholly owned by the fund. The Division of Investment Management's guidance provides that two or more venture capital funds with the same adviser, or advisers that are related persons, may each invest in the same portfolio company through a single holding company that is not owned by either of the funds, but rather is wholly owned by the funds collectively.

Alternative Investment Vehicles. To accommodate U.S. tax-exempt investors and non-U.S. investors, advisers often form an alternative investment vehicle (AIV) that exists solely to invest in the venture capital fund. The AIV does not invest in qualifying investments and therefore would technically hold more than 20% of the amount of the fund's aggregated capital contributions and uncalled capital commitments in non-qualifying investments. The Division of Investment Management stated that it would not object if an adviser relying on Rule 203(l)-1 disregards AIVs when determining if it can meet the requirements of the exemption provided the AIV is formed solely to address investors' tax, legal or regulatory concerns and is not intended to circumvent the exemption's general limitation on investing in other investment vehicles.

Warehoused Investments. Warehoused investments are investments made by an adviser while a venture capital fund is in the fundraising process, but prior to the fund being able to make investments, that are subsequently transferred to the fund. The Division of Investment Management would not object to warehoused investments being treated as though they were acquired directly by the venture capital fund from the qualifying portfolio company provided that: (i) the warehoused investment is initially acquired by the adviser (or a person wholly owned and controlled by the adviser) directly from a qualifying portfolio company solely for the purpose of acquiring the investment for a prospective venture capital fund that is actively fundraising; and (ii) the terms of the warehoused investment are fully disclosed to each investor in the venture capital fund prior to each investor committing to invest in the fund.

Main Fund/Side Fund Transfers. Advisers will often establish a venture capital fund (Main Fund) and one or more private funds to invest in parallel with the Main Fund (Side Funds). A Main Fund will sometimes transfer securities to the Side Fund(s) so that each holds its pro rata share of portfolio company securities as if each fund had made the investment on the same day on the same terms. The Division of Investment Management stated it would not object to treating such transfer as a qualifying investment provided the transfer occurs within 12 months of the final closing of the Main Fund and the potential for this type of transfer is disclosed in the constituent documents of the Main Fund and Side Funds.

Liquidating Trusts. The Division of Investment Management stated that it would not object to the use of a liquidating trust to acquire the assets of a venture capital fund as it is winding up even though the trust obtains its securities from the venture capital fund itself and not directly from a qualifying portfolio company.

Source: Investment Management Guidance Update No. 2013-13, Guidance on the Exemption for Advisers to Venture Capital Funds (December 2013).

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