

PROPOSAL TO MODIFY THE VENTURE CAPITAL EXEMPTION FROM REGISTERED INVESTMENT ADVISOR (RIA) REQUIREMENTS

Brief description:

NVCA is grateful for the exemption provided by statute that was intended to exempt all venture capital funds from the costs and challenges associated with the RIA registration requirements under Dodd-Frank. However, the definition of venture capital fund promulgated by the Securities and Exchange Commission in rule 203(1)-1 of the Investment Advisers Act was too narrow and did not meet the statutory obligations of a full venture capital exemption. The definition leaves out broad swaths of growth equity and fund-of-funds venture capital firms, constrains the investment activity of some Exempt Reporting Advisors (ERAs) who must actively avoid the regulatory morass of registration, and imposes unnecessary compliance burdens on other firms who participate in venture capital.

The definition defines a venture capital fund as a private fund that meets the following:

- A) Represents itself as pursuing a venture capital strategy to its investors and prospective investors;
- B) Holds no more than 20 percent of its aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not qualifying investments;
- C) Does not borrow, provide guarantees or otherwise incur leverage, other than limited short-term borrowing;
- D) Does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; and
- E) Is not registered under the Investment Company Act and has not elected to be treated as a business development company.

Unfortunately, this definition ignores critical elements of the entrepreneurial ecosystem that must be included to ensure that the venture capital definition most fully benefits economic growth and expanded economic opportunity. NVCA recommends the following modifications:

- Investments in Emerging Growth Companies (EGCs), whether public or private companies, should be considered qualifying investments. In addition, the purchase of qualifying investments on the secondary market should not be disqualified;
- Investments in other venture capital funds, including fund-of-funds investments should be considered qualifying investments; and
- The leverage limitations should be modified to allow for leverage up to the sum of total unfunded commitments, with a term of indebtedness up to 365 days.

There should be a simple and timely deregistration process for currently registered venture capital funds who would be exempt due to these modifications.

These modifications will create a more accurate definition of venture capital fund, easing the regulatory burden on entities important to entrepreneurial capital formation, including venture

capital fund-of-funds and growth equity investors who are not currently eligible under the SEC definition despite their prominent role in venture capital.

In addition, NVCA believes that certain low-value compliance requirements in the RIA rules should be modified to lower the significant regulatory costs associated with registration. These include:

- **Advertising Rule:** Limit Rule 206(4)-1 to only the most problematic aspects for advisers who offer the relevant marketing materials exclusively to accredited investors, qualified clients, qualified purchasers, or knowledgeable employees. Further, website information that is addressed to entrepreneurs and potential portfolio companies should be exempted from the rules, as long as all potential investor offerees are otherwise provided with compliant marketing materials. Finally, so long as the advisers are complying with anti-fraud provisions and only offer the relevant categories and have the underlying documentation proving their record from their previous firm, the portability rules shouldn't apply.
- **Maintenance of Books and Records:** Modernize the books and records provisions to ensure that the documents requested reflect the realities of today's business environment. This can also help the SEC in understanding by providing a more concise set of documents for review.
- **Investment Advisory Contracts:** Section 202(A)(12) should be amended to increase the change in control presumptive threshold for an assignment from 25 percent to a majority of voting securities.
- **Custody Rule:** The Custody Rule should be limited to only require publicly-traded securities and cash be maintained with a qualified custodian. This should include expanding the "privately offered securities" exemption so that it applies to both certificated and uncertificated securities and so that a private fund can rely on it, even where its investment adviser chooses to use the surprise examination approach rather than annual audit approach.
- **Form PF:** The additional section of Form PF should be removed for growth equity funds, which would place them on the same reporting basis as other private fund sponsors who are not large hedge funds or liquidity fund sponsors.
- **Personal Securities Transaction Reporting:** Personal securities transaction reporting should only be required for annual statements.

Impact on the ability of consumers, market participants and financial companies to participate in the economy:

Despite good faith efforts that mitigated a significant amount of potential damage, the Dodd-Frank requirement that some venture capital firms become RIAs is an unnecessary regulatory burden on the entrepreneurial ecosystem. The regulatory requirements provide little public benefit when applied to venture capital funds, which are focused on scaling startups and small businesses into successful companies. But these requirements cost hundreds of thousands (and millions, in some cases) of dollars in annual compliance costs, interferes with ordinary business practices, and can even limit the ability of many ERAs to make certain investments.

The RIA rules mandated by Dodd-Frank have created three major challenges for the entrepreneurial ecosystem:

- The venture capital exemption definition is not a complete definition, and therefore unnecessarily obliges too many firms who participate in the venture ecosystem to register with no significant public policy benefit.
- To avoid the significant pains associated with registration, a number of ERAs find their investment strategies constrained by eligibility requirements that have no bearing on systemic risk. Thus, ERAs will avoid providing investment for some young companies simply to stay away from registration.
- For those who are RIAs, the regulations contain a number of low-value compliance requirements that cost time and money and needlessly distract from their mission. This has led to hundreds of thousands, or in some cases even millions, of dollars in needless compliance costs at growth equity venture capital firms.

Impact on economic growth:

Recent research has found that young companies create an average of 3 million new jobs a year⁴, and are responsible for almost all net new job creation in the United States⁵. Further, while venture capital has invested in less than one percent of startups since 1974, venture-backed companies have been responsible for 42 percent of IPOs since then, and account for 85 percent of all public company R&D investment among this subset⁶.

When it comes to job creation, innovation, economic growth and economic competitiveness, there is no area of the economy more critical to success than the entrepreneurial ecosystem.

Because startups must operate for years in a loss position or even completely pre-revenue in many cases, investment capital is the fuel that can determine success or failure. Unfortunately, the costs and complexity arising from the RIA requirements creates unnecessary roadblocks in the entrepreneurial ecosystem despite a clear congressional intent to avoid creating such challenges.

Creating a more accurate venture capital exemption definition will protect the entrepreneurial ecosystem from the economic distortions currently created by the RIA requirements contained in Dodd-Frank, and free up needed capital for venture investment activity.

(cont.)

⁴<http://www.nber.org/papers/w16300.pdf>

⁵ <http://www.kauffman.org/what-we-do/resources/entrepreneurship-policy-digest/the-importance-of-young-firms-for-economic-growth>

⁶ <https://www.gsb.stanford.edu/faculty-research/working-papers/economic-impact-venture-capital-evidence-public-companies>