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Lending to Venture Capital Funds

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What is the Venture Capital Fund Adviser Exemption under the Investment Advisers Act and why is it relevant to loan facilities?

Historically, certain investment advisers to private funds had been exempt from registration with the SEC pursuant to the Investment Advisers Act of 1940 (the "Advisers Act") under the so-called "private adviser" exemption (*i.e.*, investment advisers who (i) had fewer than 15 clients in the preceding 12 months; (ii) did not generally hold themselves out to the public as investment advisers; and (iii) did not act as advisers to registered investment companies or business development companies). However, the Dodd-Frank Act replaced the "private adviser" exemption with narrower exemptions for advisers that advise exclusively venture capital funds (the "VC Fund Adviser Exemption"); advisers solely to private funds with less than $150 million in assets under management in the United States (the "Private Fund Adviser Exemption"); and certain foreign private advisers. (Note that advisers relying on the VC Fund Adviser Exemption or the Private Fund Adviser Exemption – generally referred to as "exempt reporting advisers" – are still subject to limited public reporting requirements, including certain parts of Form ADV, and certain limited compliance obligations.)

In its proposing release to define "venture capital fund" for purposes of the VC Fund Adviser Exemption, the SEC expressed the view that venture capital funds are "long-term investors in early-stage or small companies that are privately held, as distinguished from other types of private equity funds, which may invest in businesses at various stages of development including mature, publicly held companies." Based upon this view, as well as the SEC's understanding that such funds are "generally not leveraged," the SEC narrowly defined "venture capital fund" in SEC Rule 203(l)-1 to include, *inter alia*, funds with a limitation on the amount and duration of any indebtedness that the fund may incur (see further discussion below).

The Five Criteria for Venture Capital Funds

For purposes of the Venture Capital Fund Adviser Exemption, a "venture capital fund" is defined in SEC Rule 203(l)-1(a) to be any "private fund" (as defined in the Dodd-Frank Act, a "private fund" is any fund that would be an investment company but for the exclusions contained in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940, the "Investment Company Act") that satisfies each of the following five criteria:

- represents to investors and potential investors that it pursues a venture capital strategy (although the SEC has advised that the fund need not use the words "venture capital" in its name or otherwise: the SEC will make the determination of whether this criterion is met by analyzing the facts and circumstances of each particular case);
- immediately after the acquisition of any asset that is not a "qualifying investment" (*i.e.*, essentially equity investments in, and acquired directly from, a "qualified portfolio company," which is generally a private operating company that does not incur debt to make distributions to the fund in consideration of the fund's equity investment) or a "short-term holding" (*i.e.*, cash, U.S. Treasury securities with a remaining maturity of 60 days or less and shares of money market funds that are registered under the Investment Company Act), the fund holds no more than 20% of the fund's aggregate capital contributions and uncalled committed capital in assets (other than "short-term holdings") that are not "qualifying investments," valued at cost or fair value (consistently applied).

- does not incur leverage – whether through loans, the issuance of debt obligations, the provision of guarantees or otherwise – in excess of 15 percent of the venture capital fund's aggregate capital contributions and uncalled committed capital; and any such leverage is for a non-renewable term of no longer than 120 calendar days (except that any guarantee by the venture capital fund of a qualifying portfolio company's obligations up to the amount of the venture capital fund's investment is not subject to this 120-day limit);
- does not offer its investors redemption or similar liquidity rights (except in "extraordinary circumstances"). However, *pro rata* distributions to all holders are permissible; and
- is not an SEC-registered investment company or a business development company.

Practical Considerations

A few things to keep in mind when structuring credit facilities with venture capital funds and investment advisers relying on the Venture Capital Fund Exemption:

- Specific covenants regarding compliance with investment policies and negative covenants or default triggers should be considered for failure of a fund or its adviser to stay within the parameters of the "venture capital fund" definitions and/or the Venture Capital Fund Adviser Exemption generally.
- Subscription-line facilities should include financial covenants and conditions to borrowing tied to compliance with the maximum leverage limit in the "venture capital fund" definition, as well as borrowing clean-down provisions that require any outstanding loans to be repaid within 120 days of borrowing and subsequent drawdowns to be tied to subsequent capital calls.
- Lenders should be mindful to do careful diligence with fund constituent documents to determine the consequences of the fund's adviser violating the Advisers Act. In particular for subscription-line facilities, lenders should ensure that, following any removal of the fund's adviser or a termination of the fund's investment period as a result of the removal of the fund's adviser or the adviser's violation of the Advisers Act, investors are still obligated to make capital contributions to repay the fund's indebtedness.