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We Need to Update the Definition of a VC, Here's Why

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Last week, NVCA sent a **letter (https://nvca.org/wp-content/uploads/2018/11/NVCA-Letter-to-SEC-re-VC-Definition-Modernization-11292018.pdf)** to the Securities and Exchange Commission (SEC) offering recommendations for how the agency could modernize the definition of "venture capital fund" to more accurately reflect the industry as it looks today. Why is this important? Because this definition governs which private funds can be Exempt Reporting Advisors (ERAs) and which must register with the SEC as Registered Investment Advisors (RIAs).

Some Background

The issue of private fund registration arose during the Dodd-Frank regulatory reform bill. At the time, there was significant pressure for hedge funds and private equity funds to register with the SEC. In one of NVCA's **most significant policy accomplishments in recent memory**, and in recognition of both the plain-vanilla venture capital fund model and the critical job creation and competitiveness impact of the industry, Congress agreed to exempt venture capital funds from the registration requirements. The legislation directed the SEC to craft a definition of a venture capital fund to govern who could be eligible for this exemption. Lacking a clear-cut definition of either the nature of a VC fund or a VC portfolio, the SEC came up with a multi-factor test that required private funds to meet each parameter.

An eligible fund must meet these requirements:

- Represent itself as pursuing a venture capital strategy;

- Adhere to strict limitations on leverage both at the fund level and the portfolio company level, thus rendering any funds pursuing a leveraged buy-out (LBO) strategy ineligible;
- Not offer its investors redemption or similar liquidity rights, thus eliminating most hedge funds; and
- Hold no more than 20 percent of its total capital commitments in so-called "non-qualifying" investments.

Failure to meet any one of these factors renders a firm ineligible for ERA status. It must be noted that, by and large, the structure of this definition has been effective. The challenges today lie not with other types of firms exploiting the definition, but primarily with firms that are venture capital by every other standard definition struggling to keep themselves on the right side of the "qualifying investment" requirements. Much of this pressure is due to changes in the startup ecosystem over the last seven years since the definition was finalized.

Why Does this Matter?

The venture capital industry needs an update to this definition, or else trends in the startup ecosystem will force many firms to take on undue regulatory burdens with no material public policy benefit. **This has several consequences**, starting with those VC funds that find themselves on the wrong side of the ERA/RIA divide seeing significantly increased compliance costs. A recent NVCA compliance survey by my colleague, Maryam Haque, found that the median annual compliance costs are eight times higher for RIAs than for ERAs (estimated $405,000 vs. $50,000). And the compliance requirements don't scale well- a $500 million dollar VC firm will be paying a far higher percentage of its operating capital on compliance than a $50 billion dollar hedge fund. **This is money and time that could be used to find promising entrepreneurs and technologies, bring on additional talent to help build portfolio companies, and otherwise increase economic activity in the country.**

In addition, many of the rules of registration either don't apply to the VC business model or can even prevent firms from undertaking critical activities. A perfect example of this are the advertising rule requirements. For traditional investment advisors, these rules make sense and help govern communications with retail investors. But VC funds don't generally interact with retail investors as most of the capital in these funds are provided by sophisticated institutional investors. Instead, the rules inadvertently limit what registered VC funds can communicate to potential entrepreneurs and portfolio companies. So rather than protect retail investors from unscrupulous investment advisors looking to separate them from their money, when applied to VC funds, the rule actually creates a barrier between entrepreneurs and investors.

Finally, pushing more VC funds into registration will just further stretch the capacity of SEC regulators who will be required to spend more time examining a number of low-priority, low-risk funds without the flexibility of prioritization currently afforded them by the ERA regime. VC funds are low-risk because the VC business model is relatively straightforward. They generally do not take control of companies

which limits any risks of conflicts of interest, fees are far less prevalent in the VC model (and many VC firms operate on a 100% fee offset basis regardless), and the promise of VC investment lies almost exclusively in long-term value creation, aligning the VC, limited partners and the portfolio company. Finally, if regulators are interested in examining a VC fund who is an ERA, they *can* today, they just aren't currently *required* to do so.

Our Proposal

NVCA's letter-developed with input from our members-requests the following changes to the VC exemption definition:

- *Emerging Growth Companies (EGCs):* Make direct and secondary investments in EGCs qualifying investments. EGCs are a construct of the JOBS Act which defined on a bipartisan basis a subset of companies for which capital formation should be encouraged. EGCs must have annual revenues of less than $1.07 billion and either be private or public for less than 5 years;

- *Fund of Funds:* Make investments into other VC funds qualifying investments;

- *Cryptocurrencies:* Make crypto investments in EGCs qualifying, and allow other cryptocurrency holdings to be treated as cash or cash equivalents (in essence making them neutral investments);

- *Capital Call Lines:* Allow capital call lines for up to 365 days.

With the exception of the requested technical change for capital call lines, the proposal is focused on updating the definition of qualifying investment, something that should not surprise anybody who follows the dynamism of the U.S. startup ecosystem. In the case of secondary investments into EGCs, this is an issue that has increase significantly in prominence and need as growth companies have

continued to stay private longer. And for cryptocurrencies, the SEC can hardly be condemned for leaving out investments in a technology that was practically non-existent at the time. But seven years on, these issues bear reexamination and updates to reflect the realities of today's ecosystem.

Developing and Empowering our Aspiring Leaders (DEAL) Act

As modernization of the VC definition has become a more critical priority for startup investment, some policymakers have taken notice and provided valuable leadership. NVCA was thrilled that Rep. Trey Hollingsworth (R-IN) was able to get a bill through the House of Representatives that would direct the SEC to undertake a modernization of the definition of venture capital fund. The industry is grateful for the work he has done to rally attention and prioritization to this issue. We were further encouraged when Sen. Mike Rounds (R-SD) agreed to sponsor a Senate version of the bill. The legislative process is tricky, but it's great to see policymakers going out of their way to work on issues important to the venture industry and the startup ecosystem.

So What Happens Next?

With the proposal finalized and our official comments submitted, our next step will be working with the SEC in the hopes that they can provide feedback on our plan and find time in the already taxed rulemaking agenda to consider a modernization of the VC definition. While difficult, we have been encouraged by conversations with Commissioners and staff at the SEC, so we feel there is an opportunity to get something accomplished. In addition, we will continue our efforts to support the leadership of our advocates in Congress to push the DEAL Act forward. Modernizing the definition of a venture capital fund is one of our top priorities and we will leave no stone unturned in working with policymakers to accomplish this needed regulatory update.

For questions or comments,
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