Primum Non Nocere:

The Impact of Dodd-Frank on Silicon Valley

Eric John Finseth

Submitted in Connection with

"*Financial Regulatory Reform: Dodd-Frank and Beyond*"

a Symposium Sponsored by the

Berkeley Center for Law, Business and the Economy

March 2011

Introduction.

Western medicine has, thankfully, in the past several centuries advanced beyond drilling holes in the head to release evil spirits and bleeding patients to drain them of foul humors. Advances in medical knowledge, coupled with a maxim of the profession, *primum non nocere*, "first of all, do no harm," deserve substantial credit. That same prophylactic maxim should likewise apply, mutatis mutandis, in the legislative and regulatory arena.

With near inevitability, remedial legislation often follows in the wake of crises and significant scandals. Just as Enron, Worldcom and other cases of corporate misconduct flushed to the surface by the tech sector crash at the turn of the millennium triggered passage of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"), the systemic credit crisis of 2008 which rocked the financial world led to enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] Critical inquiries, of course, in connection with any such regulatory endeavor are whether the causes of the late crisis have been properly identified, whether existing laws are adequate (and the crisis was merely on of those catastrophes which one must stoically expect to recur from time to time in human affairs) or whether fresh legislation might help better address those causes, and whether the cure does more harm than the disease itself.

Whoever and whatever the causative parties, acts and circumstances leading to the credit crisis were, and here theories abound, often aligned along axes of political sympathy and ideological conviction, one point stands clear and uncontested: Silicon Valley was not at fault. High tech startups and the venture capital ("VC") funds which help to finance them were not

[1] Pub. L. No. 111-203, 124 Stat. 1915 (2010) [hereinafter Dodd-Frank Act].

noticeable participants in the mortgage-backed securities industry, nor in the market for credit default swaps or other derivative instruments. They were far more insulated than the financial sector generally from the use of leverage and the creation of counterparty relationships which can lead to daisy chain transmission of financial distress from one entity to another.

As Congress and the Securities and Exchange Commission ("SEC") have moved and going forward proceed to address what they perceive to be sources of systemic risk to the U.S. financial system, it is important that the legislative and regulatory effort endeavors to avoid adverse collateral consequences to portions of the economy not implicated by the recent crisis. Do the Dodd-Frank Act and the SEC's proposed implementing regulations to date cohere with that guiding principle, as least as regards the high-tech startup financing process?

In one important respect the Dodd-Frank Act sought to avoid unintended deleterious impact on the VC industry by providing a specific exemption for VC funds from registration requirements under the Investment Advisers Act of 1940 (the "Advisers Act") which the act otherwise mandated for much of the rest of the private fund management industry. In a few respects, however, the act and the SEC's proposed implementing regulations thereunder impose requirements and restrictions which at the margin add to the collection of regulatory speed bumps with which the startup financing process must contend. It is open to question whether attainment of the regulatory objectives anticipated from those additional speed bumps merits the incremental burden they impose.

The Tightened "Accredited Investor" Definition.

An aspect of the Dodd-Frank Act which has particular relevance to Silicon Valley is the act's tightening of the "accredited investor" standard under the Securities Act of 1933 (the

"Securities Act").[2] Specifically, Section 413 of the Dodd-Frank Act directs the SEC to adjust its definition of the term to exclude the value of a natural person's primary residence in calculating whether that person meets the $1 million net worth standard for accreditation. The act also directs the SEC to periodically review its accredited investor definition, presumably with an eye toward raising the dollar thresholds featured in various accredited investor categories "in light of the economy," viz in light of general inflation.

The Rationale for Congressional Intervention on Point.

A question which naturally arises here is why Congress chose to intervene in this regard. Were there significant abuses or classes of investors who had been hurt during the recent crisis as a result of too lax a net worth standard for accreditation? That Congress may have had a premise along these lines is suggested by Section 415 of the Dodd-Frank Act, which directs the Comptroller to conduct a study "on the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and *eligibility to invest in private funds*…." (emphasis added).

Admittedly, the creeping progress of inflation over the years incrementally erodes the significance of any fixed dollar threshold. Since the SEC's adoption in 1982 of the current Regulation D standards under which a natural person qualifies as an accredited investor if they have net worth of $1 million, or have had individual income of $200,000 in each of the two

---

[2] The term "accredited investor" plays an important role under the Securities Act, most notably in Regulation D and very specifically in Rule 506 thereof, as discussed *infra*. The term is defined in Rule 501(a) for purposes of Regulation D, as well as being either referred to or defined in Sections 4(6) and 2(a)(15) of the Securities Act and in Rule 215 thereunder (Rule 215's definition not being as broad in certain respects as Rule 501(a)'s definition).

Broadly speaking, accredited investors include an array of institutional investors, entities having assets in excess of $5 million, and certain natural persons (along with entities of which all the equity owners are accredited). Other than persons in a control relationship with the issuer, to be considered accredited a natural person generally must either have net worth (alone or with spouse) in excess of $1 million, or must have had individual income in excess of $200,000 (or with spouse, $300,000) in each of the two most recent years and have a reasonable expectation of reaching the same income level in the current year.

preceding years and a reasonable expectation of the same in the current year (or $300,000 with spouse),[3] the Consumer Price Index has on a compounded basis increased by roughly 130%,[4] thus cutting the real as opposed to nominal dollar thresholds by more than half. Occasional adjustment of fixed dollar thresholds can clearly be appropriate to maintain a standard relatively constant in real terms.

In this regard, SEC Commissioner Luis Aguilar has observed that due to the rise over time in real estate values, there may be persons who now meet the net worth standard for accreditation who nonetheless do not possess sophistication in financial matters or a practical ability to protect themselves in financial transactions.[5] From the SEC's traditional investor protection standpoint, this becomes an area worthy of attention.

Setting a specific dollar threshold, however, is precisely the sort of detailed, down in the weeds regulatory endeavor which Congress has historically generally, and in the case of the accredited investor definition quite specifically, delegated to the SEC as administrative executor of the securities laws. Section 2(a)(15) of the Securities Act indicates that the term "accredited investor" shall mean inter alia "any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe." It is thus, if not necessarily unprecedented, certainly unusual for Congress to reach down into the regulatory minutiae and dictate a matter of this kind.

---

[3] *See* Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Release No. 33-6389 (Mar. 8, 1982). The $300,000 joint income level was added to the definition a few years later. *See* Regulation D Revisions, Release No. 33-6758 (Mar. 3, 1988).
[4] *See* InflationData.com, http://inflationdata.com/inflation (last visited Feb. 27, 2011) (calculation run over compounding period from Mar. 1982 through Jan. 2011 yields cumulative inflation of 133%); U.S. Dept. of Lab., Bureau of Lab. Stats., http://www.bls.gov/data/inflation_calculator.htm (last visited Mar. 7, 2011) (calculation run over compounding period from 1982 through 2011 yields cumulative inflation of 128%).
[5] Luis A. Aguilar, Commissioner, SEC, Address at UC Berkeley Law School (Boalt Hall) (Oct. 15, 2010).

Impact on Private Placements.

Whatever the explanation for Congressional intervention may be, the inquiry then turns to what, if any, impact this alteration of the net worth accreditation standard for natural persons may have. In this respect, it worth returning to the historical record as regards capital formation for fledgling enterprises. As noted by professor John Coffee, "During the 1980s, spurred both by academic criticism and congressional pressure, the SEC used its exemptive powers to broaden expansively the opportunities for an issuer to offer and sell substantial amounts of securities without registration. … Partly in consequence, the venture capital industry burgeoned in the 1980's." This in turn "fueled the growth of Silicon Valley."[6]

Specifically, the adoption by the SEC of Rule 506 of Regulation D in 1982, under which an issuer may sell unlimited dollar amounts of securities to unlimited numbers of accredited investors without specific disclosure requirements (though subject to a prohibition on general solicitation and, as always, to general antifraud provisions) effected a sea change as to private placements. That rule is the workhorse provision upon which nearly the entire private company and VC fund capital formation process relies, and that rule in turn is driven almost entirely by the definition of the term "accredited investor." Tightening the definition of accredited investor necessarily and directly throttles back on the ease of conducting private placements. Theoretically, this makes it at the margin more difficult for startup companies to raise money to finance operations, and makes it more difficult for VC funds to form.

As Applied to Typical Silicon Valley Capital Formation Activities.

The good news in all this is that the specific alteration mandated by Congress is highly unlikely to have much practical effect as to the class of investors typically behind VC funds, and

[6] JOHN C. COFFEE, JR. & HILARY A. SALE, SECURITIES REGULATION 344-45 (Foundation Press 11th ed. 2009).

is not likely to have much impact on professional venture capital financing rounds in which VC funds invest in startups. Where it may have a more tangible impact, however, is on so-called "friends and family" financing rounds in which a startup enterprise not yet sufficiently established to attract investment from VC funds is struggling to get off the ground. Yet this is often the breeding ground for startups which in due course do come to the favorable attention of VC funds.

This differential impact on different issuers arises due to the types of investors which they seek to attract. VC funds typically draw their own investors from the ranks of major pension funds, university endowments, and individuals so wealthy that they easily blow through any natural person accreditation standard which could be set.

Similarly, startup companies raising money in a typical venture capital financing round often permit natural persons to invest in preferred stock alongside the VC funds, but these persons constitute mere icing on the cake. The overwhelming majority of the money raised is from the VC funds, and the individual investors are permitted to get in on the company's equity primarily as a concession to them as friends of the company rather than as a result of fundraising necessity. Tightening the accredited investor net worth standard might disqualify some of these individuals, but is not particularly likely to have too much of a material impact on the financing effort of startup companies in which VC funds have become interested.

In a friends and family round, however, natural person investors are the cake itself. While many natural persons who qualify as accredited may meet both the $1 million net worth test as well as the $200,000 annual income test, not all will. The type of person to meet the former but not the latter, and who may thus have just been squeezed out of the private placement equation by the Dodd-Frank Act, is someone who may well have had comfortable income throughout their life, now owns a valuable personal residence, but is no longer as professionally active as they once were and may at this point have annual income below $200,000. That is, a retired person.

Unfortunately, relatively affluent retired persons from the older generation may often constitute much of the pool of friends and family to whom a struggling young entrepreneur might turn in the all-critical search for seed capital to fund the entrepreneur's concept for a new startup business.

Since private placements are not subject to detailed reporting requirements (other than the summary Form D filed with the SEC), it is not easy to ascertain for certain what percentage of money raised in private placements comes from natural persons who satisfy the net worth standard but not the income standard for accreditation.[7] Some information may nonetheless be gleaned from the 2007 Federal Reserve Board Survey of Consumer Finances. Using data from this source, the SEC calculated that prior to the Dodd-Frank Act, approximately 9.04% of U.S. households qualified as accredited based on the net worth standard, while approximately 6.55% so qualified following passage of the act. That is, slightly more than a quarter of such persons were removed from the net worth category by the act. Again, some of those persons removed from the net worth category might nonetheless continue to be eligible as accredited under the income standard, but these numbers do convey some sense of the act's impact in this regard.

[7] The best source of information in this regard may well be legal practitioners who have extensive personal experience reviewing accredited investor questionnaires in connection with various types of private placement financing rounds by both startup companies as well as by venture capital funds. In the author's experience over the course of a decade and a half of such work, among natural person accredited investors there is perhaps roughly equal frequency of persons who check solely the box for $1 million in net worth, and those persons who check both the $1 million in net worth as well as the $200,000 in annual income boxes. Probably slightly less frequent have been persons checking solely the $200,000 in annual income box. These estimates are necessarily impressionistic in nature and not the subject of rigorous empirical study, but they give perhaps some sense that persons indicating solely the $1 million in net worth category of accreditation represent a fair number of natural persons investing in such private placements.

What is of course even more difficult to say is what the ultimate practical impact may be on the ability of small startups to raise money from friends and family, but the matter is worthy of continuing observation over time.

The VC Fund Exemption and Its Implementation.

Dodd-Frank and the Registration of Private Fund Advisers.

A second aspect of the Dodd-Frank Act bearing particular relevance for Silicon Valley is its impact on VC funds. Prior to enactment of the Dodd-Frank Act, many private fund advisers, ranging across fund types such as hedge funds, private equity funds, real estate funds and VC funds,[8] were able to avoid federal registration under the Advisers Act by relying upon an exemption for parties advising 14 or fewer fund entities. In order to give the SEC greater insight into hedge fund and other private fund activities and any potential relationship of those activities to systemic risk in the financial system, Congress chose to repeal Section 203(b)(3) of the Advisers Act, which had contained the 14-or-fewer exemption, thus broadly compelling Advisers Act registration by all private fund advisers.

The VC Fund Exemption.

Sensibly, in view of broad recognition that VC funds had not played a contributory role in the 2008 credit crisis and that it would be counterproductive for the American economy as a whole to impose significant regulatory burdens upon VC funds as an ancillary byproduct of the statute's focus on private funds more generally, Section 407 of the Dodd-Frank Act provides that VC funds are to be exempt from this Advisers Act registration requirement. Section 407

[8] "Private funds" are broadly defined by Section 202(a)(29) of the Investment Advisers Act of 1940 (the "Advisers Act") as investment funds not regulated in the same manner as mutual funds by virtue of such investment funds' reliance on exceptions from the definition of "investment company" contained in Sections 3(c)(1) and/or 3(c)(7) of the Investment Company Act of 1940 [hereinafter '40 Act].

instructs the SEC to define the term "venture capital fund" for this purpose. The section also provides that the SEC "shall require such [VC fund] advisers to maintain such records and provide to the Commission such annual or other reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors."

SEC Implementing Releases.

In Nov. 2010 the SEC put forth two proposed implementing releases in this regard. One of them addresses the contours of the VC fund exemption, along with similar registration exemptions for funds with less than $150 million under management and for foreign private advisers (the "Exemptions Release").[9] The other proposes to require VC funds and other exempt private fund advisers regularly to provide to the SEC a subset of the information which registered advisers are required to provide (the "Reporting Release").[10]

The Definition of Venture Capital Fund.

The Exemptions Release sets the scope of the Dodd-Frank Act's self-executing VC fund exemption simply by defining the term "venture capital fund" for purposes of Section 203(l) of the Advisers Act. In essence, VC funds are defined as any kind of private fund which makes portfolio investments solely in private operating companies ("qualifying portfolio companies," discussed in detail below), and solely in equity securities thereof, does not incur significant leverage in connection with its investments, and plays or offers to play a tangible role in the operational management of such portfolio companies. Quite early in the process of tackling that definition, however, tension emerges between one of the two main policy rationales for

---

[9] Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, SEC Release No. IA-3111 (Nov. 19, 2010) [hereinafter Exemptions Release].

[10] Rules Implementing Amendments to the Investment Advisers Act of 1940, SEC Release No. IA-3110 (Nov. 19, 2010) [hereinafter Reporting Release].

exempting VC funds and the SEC's ability to draw a robust distinction between VC funds and other types of private funds not intended by Congress to be eligible for exemption.

Policy Rationale for Exempting VC Funds.

Those two foundational policy considerations behind the VC fund exemption were clearly and succinctly articulated by SEC Chairman Mary Schapiro during her remarks at the SEC Open Meeting at which the Exemption and Reporting Releases were proposed, namely (i) that VC funds do not use leverage to make their investments, and (ii) the nature of the startup operating companies in which they invest.[11] In other words, VC funds are not interconnected with other parts of the financial industry in a manner which gives rise to systemic risk concerns. And the entrepreneurial startup business activity which they do so much to encourage is both vital to U.S. economic growth and likewise bears little connection to financial sector systemic risk concerns.

The Difficulty in Defining "Startup Company."

The Exemptions Release points to a practical difficulty encountered by the SEC: "There appears to be little consensus … as to what a start-up company is." This goes to the heart of the second policy consideration articulated by Chairman Schapiro. To the extent that no convincing definition of startup company for purposes of the rule is ultimately achieved, consequently greater pressure is placed on the attempt to distinguish VC funds from other private funds in some alternative manner which may not be as tightly related to the true policy rationales for exempting VC funds in the first place. Moreover, to the extent that alternative bases for distinguishing VC funds potentially might strike one as rather thin or even arbitrary, VC funds

[11] *See* SEC Chairman Mary L. Schapiro, Remarks at Open Meeting of the SEC (Nov. 19, 2010) [hereinafter Proposing Open Meeting], *available at* http://www.sec.gov (follow "Webcasts" hyperlink, then follow "SEC Open Meetings" hyperlink, then follow "Webcast Archive" hyperlink for Fri., Nov. 19, 2010).

could start to look, from the point of view of some among the SEC staff, suspiciously like any other type of investment fund – VC funds do, after all, invest in securities just like other private investment funds. "Why shouldn't they be forced to register as investment advisers just like all the others?," the staff might ask. Query whether such thoughts might have influenced the staff and the Commission majority in the Reporting Release to propose to introduce SEC reporting requirements for VC funds, coupled with the Exemption Release's assertion of SEC examination authority with respect to such funds' book and records, which may be expected to entail an increase in overall legal compliance costs faced by such funds. This and other potential consequences of the definitional difficulty will be discussed further below.

The Definition of "Qualifying Portfolio Company"; Recommendations for Revision. In light of the foregoing, the SEC's proposed startup company definition is fairly simple. Under the proposals, a "qualifying portfolio company" is, in essence, a private operating company. The technical definition specifies that to be considered a qualifying portfolio company, the recipient of the venture capital investment must be a company which (i) is not publicly traded, (ii) is not controlled by or under common control with a public company, (iii) does not borrow or issue debt obligations in connection with the venture capital investment, (iv) does not redeem, exchange or repurchase any of its securities, or make a distribution to preexisting securityholders, in connection with the venture capital investment, and (v) is not a mutual fund, any type of private fund relying on the Section 3(c)(1) or 3(c)(7) exceptions to the definition of "investment company" under the '40 Act, an asset-backed issuer relying on the Rule 3a-7 exception to the definition of "investment company," or a commodity pool.[12]

---

[12] Exemptions Release at 132-33.

Should Industry Specificity Be Revisited?

Notably, the proposed definition of qualifying portfolio company does not attempt to restrict the definition to the high tech startups in Silicon Valley and other technology centers which were presumably at the heart of Congress' determination to exempt VC funds. Other than excluding various types of investment entities as detailed above, the definition leaves the type of portfolio business activity completely open.

It is not clear that this is necessarily a wise choice. In the Exemptions Release the SEC specifically invites public comment as to whether the definition of VC fund should apply only to funds that invest exclusively or primarily in companies operating in nonfinancial sectors.[13] Similarly, the SEC invites comment as to whether investments in certain additional types of pooled investment vehicles (e.g. real estate funds or structured investment vehicles) should also be disqualified.[14] It would seem potentially advisable to impose certain further limitations of this kind as to the types of permissible investment for the simple reason that by tailoring the definition of VC to the true policy reasons undergirding their exemption from registration, alternative requirements under the proposed definition which are not as closely related to the underlying policy, and which may unduly restrict or alter typical VC behavior, may consequently be relaxed. It is easiest to walk around in a shoe that fits well. Certain areas which could be rendered more accommodating to actual VC practice are discussed below.

Public Companies as Strategic Investors and as Sponsors of VC Investment Arms.

An aspect of the proposed definition of qualifying portfolio company which pinches too tightly is the requirement that the portfolio company not be controlled by or under common control with a public company. This might easily disqualify quite a few high tech startups

[13] Exemptions Release at 27.
[14] *Id.* at 35.

initially sponsored by or receiving significant investments from public companies or their VC investment arms. As two examples among many, Intel Capital, associated with Intel, and Norwest Venture Partners, associated with Wells Fargo, provide venture capital financing to high tech startups. Similarly, quite a few public operating companies make direct venture capital investments in high tech startups as a means of building relationships, gaining a window into new technical and business developments, and creating the foundation for strategic partnerships or future acquisition activity.[15]

At the heart of the Gordian knot here is that the term "control" is not itself defined with precision, and the fact that control arrangements in the venture capital arena are complex and multifaceted, involve both positive and negative powers, and are often shared by or allocated among multiple actors in custom-tailored patterns.[16] There are thus a number of potential interpretations of the term control which might have applicability in the venture capital context.

[15] Operating companies making such venture capital investments are often referred to in the startup context as "strategic investors."

[16] The typical venture capital financing transaction involves the sale by a private operating company of a specifically designated new series of preferred stock (e.g. "Series A Preferred," "Series B Preferred," and so on) and is based on the following classic set of transaction documents: (i) an amended charter (certificate of incorporation) setting forth the rights, preferences and privileges of the company's capital stock, including the new series of preferred; (ii) an amended set of bylaws; (iii) a stock purchase agreement; (iv) an investor rights agreement; (v) a right of first refusal and co-sale agreement; and (vi) a voting agreement.

From a control perspective, the charter typically indicates how directors shall be elected to the board (e.g. "the holders of Series A Preferred are entitled to elect two directors," etc.), specifies special voting rights of certain directors (e.g., "the company shall not issue any capital stock having rights, preferences or privileges senior to or on parity with those of the Series A Preferred without approval of the two directors elected by the Series A Preferred"), and sets forth so-called "protective rights," i.e. veto rights of certain specified series or classes of stock (e.g. "the company shall not merge with or into another entity without approval of a majority of the outstanding shares of Series A Preferred). Likewise, the typical voting agreement obligates all of the major shareholders of the company, generally the founders and the VCs, to vote their shares as specified in the agreement in order to elect specified designees to the board (e.g. "all signatories to this agreement shall vote their shares so as to cause the election to the board of two persons designated by holders of a majority of the outstanding shares of Series A Preferred").

For a representative example of the set of documents classically involved in a venture capital financing transaction, reference may be made to the model documents developed by the National Venture Capital Association. National Venture Capital Association, http://www.nvca.org (follow "Model Legal Documents" hyperlink) (last visited Feb. 28, 2011). These model documents tend in certain respects toward the "investor friendly" end of the spectrum relative to typical Silicon Valley practice, but they amply demonstrate the structures and types of issues addressed in such a transaction.

For example, would a publicly traded strategic investor, or a VC fund associated with a public company, that obtains a seat on the board of directors (as typically happens for all key investors) be considered to have "control" of the portfolio company? What if the strategic investor or fund enjoys, as is typical, either alone or along with other key investors, veto rights in its capacity as a shareholder which are anchored in the portfolio company's charter with respect to a variety of corporate actions, such as mergers, securities issuances, etc. (typically referred to as "protective rights")? What if, as very often occurs, such protective rights are also formalized by providing that various specified corporate actions cannot be undertaken without approval of the directors elected by one or more given series of preferred stock? What about the typical situation where the portfolio company and its major investors have entered into a voting agreement obligating the parties to elect to the portfolio board of directors designees of the various parties as specified in the agreement?

It would thus appear helpful for the proposals either to drop altogether the requirement that the qualifying portfolio company not be controlled by or under common control with a public company, or for the proposals to be revised to clarify certain commonly occurring circumstances which would not be deemed to constitute control for these purposes. For example, the rule or the adopting release could specify that enjoying the right to determine one or more seats on the board of directors would not constitute control of a portfolio company as long as such seats constitute only a minority of the total board. Likewise, it should be clarified that neither the presence of protective rights of either variant discussed above, nor the presence of a voting agreement specifying board designation rights, should be considered to constitute control. The definition of control for purposes of the rule could thus be reduced to situations where a publicly traded strategic investor or investment fund sponsored by such a public company either enjoys a majority of the total voting power on the board of directors, or has the affirmative power by contract or rights anchored in the charter to initiate and direct the conduct of day-to-day operations of the portfolio company (as distinct from the negative veto rights characteristic of protective rights).

The Managerial Guidance or Control Requirement; Recommendation for Clarification.

Another proposed requirement in the Exemptions Release for a fund to fall within the definition of VC fund is that, with respect to each qualifying portfolio company, the fund either (i) offers to provide, and if accepted, does so provide, significant guidance and counsel concerning the management, operations or business objectives and policies of the qualifying portfolio company, or (ii) controls the qualifying portfolio company.[17]

Stepping back for a moment to the policy perspective, the rationale for this proposed requirement appears slightly less obvious. Is it related to the use of leverage and the risk of counterparty daisy chains spreading contagion from one financial institution to another? Does it precisely contain the scope of the exemption to true venture capital activity supporting small, startup businesses?

Again, it will be important to ensure that this requirement is not interpreted in a manner which inadvertently cuts into legitimate, beneficial venture capital financing activity which benefits the American economy without raising tangible systemic risk concerns. For example, it is typical that multiple VC funds will have invested in a particular portfolio company over the life of that company prior to an acquisition or initial public offering. Not all of those VC funds will necessarily enjoy the right to designate a board member. Of those without a board member, not all will enjoy the contractual right to appoint a board observer. Nor will they have

[17] Exemptions Release at 131.

contractual or charter rights to direct the activity of the company (at most they would typically participate in pooled protective rights with one or more other series of preferred stock), such that they could not reasonably be said to have control. And yet those VC funds will have provided truly speculative venture capital to a highly risky, unproven young enterprise, precisely the economic activity which Congress appears to have been seeking to insulate from undue regulatory imposition.

The matter is complicated by the fact that board meetings constitute the central and most important forum at which representatives of the VC funds communicate guidance, counsel and advice to a portfolio company's CEO, CFO and other key officers.

The language of the proposed provision, of course, offers potentially great latitude in this respect. The requirement can be satisfied merely by offering to provide managerial guidance and counsel, an offer which need not be accepted. The policy concern articulated above could therefore be addressed simply by explicitly specifying in the rule's ultimate adopting release that a VC fund need not have board representation or a board observer in order to be considered to have offered significant managerial guidance or counsel. As long as it is sufficient that a good faith offer of the auspices and advice of the fund have been made, the rule would not disqualify such smaller, noncontrolling VC investments from eligibility.

Bridge Financings and Venture Debt Funds.

Finally, the proposed rule generally requires that a VC fund invest solely in equity securities.[18] For the most part, this requirement should not pose any difficulties for the typical VC investment, namely the purchase of convertible preferred stock. There are two circumstances, however, where a strict equity-only requirement may pinch a bit too tightly,

[18] *Id.* The funds are also permitted to hold cash, cash equivalents, and U.S. Treasury obligations of specified remaining maturity.

namely bridge or other VC debt financing using a nonconvertible promissory note, and so-called "venture debt" funds.

Preliminarily, it should be noted that the definition of equity securities for this purpose is quite broad. The proposed rule indicates that "equity securities" would have the meaning set forth in Securities Exchange Act of 1934 Section 3(a)(11),[19] which sweeps into the definition of equity any stock or similar security, any security convertible into such a security, or carrying any warrant or right to subscribe to or purchase such a security, or any such warrant or right. Thus, a bridge financing in which a VC loans money to a portfolio company, and the loan is evidenced by a promissory note which contains a provision permitting the holder to convert the note into stock, would still qualify as an equity investment.

If the lawyers drafting the document failed to include an explicit conversion provision in the note, however, the bridge financing would not so qualify. This might be a potential trap for the unwary. To avoid the problem, all such bridge notes would need to contain explicit conversion provisions.

The requirement might also pose difficulties for so-called "venture debt" funds which are in the business of making somewhat lower return, lower risk investments in inherently highly risky startup companies by structuring their investments primarily as debt rather than stock. A practical requirement that, to avoid registration as investment advisers, such venture debt funds would need to bargain for explicit conversion provisions in all their loan documentation might potentially divert certain current business practices from their accustomed course. Situations can arise where there is sensitivity among the venture capitalists as to who precisely will be admitted to the list of equityholders of a company (equity is often greatly prized and carefully allocated, as

[19] *Id.* at 132.

it affects both control and represents the potential golden prize at the end of the startup rainbow). Negotiating points may also arise as to the terms on which an instrument might convert.

Focus on the Realistic Risk of Systemic Implications.

Although these are not fundamental concerns with the Exemptions Release, it seems fair to inquire whether a strict equity-only requirement is necessary in all circumstances. From a policy perspective, the proposed equity-only requirement appears driven by the concern with potential systemic risk. The use of leverage and the creation of other daisy chains under which one institution's distress may easily topple another domino in the row, would seem to be the principal points to be addressed. However, VC funds would generally appear to be largely immune to such risks and dependencies, at least relative to the rest of the financial industry. They typically receive contractual commitments from investors which run over a period of 10 or so years – the fund may make capital calls from time to time upon investors predicated upon those commitments, and the investors must pony up money to meet the call. Nor are VC funds typically subject to redemption provisions under which investors can demand their money back on a short-term basis. Investors are in for the long haul. Further, a VC fund's operative documents typically sharply restrict the fund's ability to borrow money – only short-term borrowing is typically permitted, and only up to some limited percentage of overall capital commitments to the fund. Borrowing is typically only engaged in to bridge the period between a capital call and receipt of monies from investors pursuant to the call.

As a result of the foregoing, the distress of other financial institutions does not lead in the short term to situations in which parties which have advanced or contributed money to a VC fund are in any kind of position to demand that money back. The VC fund is largely immune to pressure. The VC fund therefore typically will not find itself in a cash crunch position where it would need to lean hard on a portfolio company to pay off a debt to the fund. The VC fund thus need not transmit distress to a portfolio company and does not act as a domino in a chain.

Because there is little risk of a VC fund finding itself in a position where it needs to pull back credit previously advanced by the fund, it would appear perhaps not unreasonable to permit VC funds to make investments in qualifying portfolio companies which are not structured as either straight equity or instruments convertible into equity.

Prophylactic Antiabuse Measures.

Admittedly, there is always the perennial cat-and-mouse game between regulators and private industry to consider. Regulators are often concerned, and not infrequently rightly so, that if they unduly relax a rule, private industry will find ways to construct arrangements which, while not in technical violation, eviscerate the policy objective which originally motivated the regulatory structure. The SEC might therefore be concerned that permitting instruments other than equity might permit a fund claiming the VC fund exemption in fact to engage in, for instance, derivatives transactions in ways not yet foreseen and which might be of interest to the agency from a systemic risk perspective.

Concerns of this type might, however, be addressed by limiting the types of permissible nonconvertible, nonequity instruments solely to straight promissory notes, i.e. not containing any more elaborate "structured finance" features. Further, such promissory notes might be considered eligible investments only in circumstances where the fund has already made, or reasonably expects to make, an equity investment in the portfolio company.

The New SEC Reporting Requirement.

A more problematic aspect of the legislation and rule proposals arises in the context of the Reporting Release. Here, the SEC has proposed to require that all VC funds, although exempted from full registration requirements under the Advisers Act, nonetheless become for the first time subject to SEC recordkeeping and reporting obligations. The proposed required disclosures constitute what is in essence a "Form ADV lite," i.e. a subset of the full Form ADV disclosures applicable to registered advisers. Furthermore, the Exemptions Release indicates that the SEC has "authority to examine the books and records of advisers relying" on the VC fund registration exemption.[20]

Certainly the SEC has authority (and potentially an obligation) under the Dodd-Frank Act to impose some form of reporting requirements for VC funds.[21] The query, rather, is whether it is truly "necessary or appropriate in the public interest or for the protection of investors" to impose more than trivial reporting requirements on VC funds.

Reporting requirements would appear to make sense if there were repeated or significant examples of fraud or abuse in the VC fund sector, or the SEC were to require more transparency into the sector in order to ensure that systemic risk concerns do not arise. The author is unaware, however, on the basis of many years of personal experience with VC funds both as regards their own fundraising efforts as well as their investment activities, of any such record of fraud or abuse in the sector as to merit imposition of SEC reporting compliance costs. And by common consensus the VC fund sector does not raise systemic risk concerns. From a policy perspective, these considerations militate against reporting obligations altogether, or at a minimum against obligations that go beyond the truly necessary.

It is therefore worthy to note that although VC funds will under the proposals only need to provide certain elements of Part 1 of Form ADV, and will not need to provide the client brochure specified in Part 2 of Form ADV, the Reporting Release proposes to expand the

[20] *Id.* at 8.
[21] Dodd-Frank Act § 407.

disclosures required under Section 7.B.1 of Schedule D.[22] These expanded disclosures will be required of VC funds, and include discussion of "characteristics of the fund that may present the fund manager with conflicts of interest with fund investors of the sort that may implicate the adviser's fiduciary obligations to the fund and, in some cases, create risks for the fund investors," along with information concerning various service providers to the fund. As explained by the SEC, "we are proposing significant amendments to Section 7.B.1 of Schedule D that are designed to provide us with a comprehensive overview, or census, of private funds."[23]

The Cost/Benefit Calculus.

Moreover, the indication in the Exemptions Release that VC funds would now for the first time become subject to SEC examination authority suggests that VC funds may face tangibly higher compliance costs going forward. The logical response to SEC reporting obligations and the prospect of direct regulatory examination is to increase the number of a fund's legal and compliance personnel and to hire outside counsel experienced in Advisers Act matters. In light of the higher costs which should thus be anticipated, SEC Commissioner Kathleen Casey stated in her remarks at the SEC Open Meeting at which the proposals were approved that, in order to remain true to Congress' intent that there be a meaningful distinction between the level of regulation faced by VC fund advisers as distinct from registered advisers, the SEC should not claim examination authority as to VC fund books and records. As she put it,

[22] Exemptions Release at 42.

[23] Reporting Release at 42.

The information required by Section 7.B.1 of Schedule D include inter alia: (i) the current value of the fund's investments broken down by asset and liability class and categorized in the fair value hierarchy established under GAAP (i.e. Level 1, 2 or 3 measurements); (ii) certain information concerning investors in the fund; and (iii) certain information concerning various service provides to the fund, such as its auditors. VC funds will also be required to provide information on their control persons, and disciplinary history on all "advisory affiliates" of the fund. Prompt updates are required with respect to some elements of the information provided. As a practical matter, funds will find it necessary to obtain certain information from its outside service providers as well as its employees and control persons, and monitor the information provided for changes in status.

the assertion of examination authority collapses the difference between "exempt reporting advisers," such as VC funds, and fully registered advisers.

Particularly troubling is the evident disconnect between the agency's estimate of compliance costs with the proposals and the expenditures in fact typically incurred in complying with SEC regulatory and reporting requirements. Although in the author's experience the staff of the SEC are highly honorable, honest, competent and thorough, one consistent area of regulatory failure is in the production of realistic estimates of how long it takes to comply with SEC reporting requirements, and the kind of professional training and expertise required to do so. Specifically, the SEC has estimated that only seven hours would be necessary for an advisor to five VC funds to comply with the new reporting requirement initially, and that this number would decrease significantly in later years. This estimate bears no reasonable relation to reality. The actual disclosure process involves becoming aware of the new regulatory requirements, carefully reviewing them with both in-house administrative and legal personnel as well as outside counsel, preparing draft disclosures, vetting those disclosures with all relevant parties including the fund's principals and investment personnel, training administrative staff or hiring outside providers to assist in the SEC electronic filing process, etc. The total investment of time which should be expected is thus markedly higher than the agency has estimated, and would involve not only internal nonlegal administrative personnel but also costly expenditures on both in-house and quite likely outside professional counsel.

The upshot of all this is that VC funds may be expected to begin incurring higher legal compliance costs than they have heretofore. Though for larger VC funds this may not pose a problem, it may at the margin make it more difficult for smaller funds to produce adequate returns to their own investors and may exert some discouraging effect on new entrants to the field. In the absence of a clear policy justification for the incremental burden, it is legitimate to question its advisability.

The Volcker Rule and VC Funds.

A third aspect of the Dodd-Frank Act which may have particular relevance to some in Silicon Valley is the so-called "Volcker Rule," set forth in Section 619 of the act.

A major objective of the Volcker Rule is to reduce the risk profile of banking entities by generally prohibiting them, subject to certain exceptions, from (i) engaging in proprietary trading, and (ii) either sponsoring, or acquiring or retaining any ownership interest in, hedge funds and private equity funds. The rub for Silicon Valley is that the rule defines hedge funds and private equity funds in a very simplistic, broad manner which sweeps in many types of private funds, such as VC funds.

Section 619 of the Dodd-Frank Act defines the terms "hedge fund' and "private equity fund" to mean any and all funds that would be considered "investment companies" but for their reliance upon Section 3(c)(1) or 3(c)(7) of the '40 Act, along with any other similar funds as regulators may designate. Because they are in the business of investing in securities, VC funds typically rely on such Sections 3(c)(1) and/or 3(c)(7) in order to avoid being regulated under the '40 Act in the same manner as mutual funds. If applied in this fashion,[24] banking entities

[24] The Federal Reserve recently issued regulations regarding the conformance period for the Volcker Rule to be observed by banking entities. Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. 8265 (Feb. 14, 2011) (to be codified at 12 C.F.R. pt. 225).

associated with VC funds may in many instances need to divest themselves of their interest in such funds and terminate any control relationships that might exist with respect to such funds.[25]

The obvious recommendation in this regard is for this definition to be tailored more narrowly to the typical activities of hedge funds and private equity funds, or for specific categories of funds which do not implicate systemic risk concerns to be carved out of the definition, in either case in a manner which exempts VC funds from the Volcker Rule's divestiture and noninvestment mandate. A suggestive nod in this direction has recently been made in a study conducted by the Financial Stability Oversight Council.[26]

Conclusion.

The Dodd-Frank Act is sweeping legislation which affects the entire financial industry on a nationwide basis, and can thus be expected to have a variety of impacts on Silicon Valley, and Northern California more generally, in roughly like manner as it affects many other parts of the country. Rather than entering upon a discursive analysis of the Dodd-Frank Act generally, this focus of this article has been on those specific elements of the act which more particularly and peculiarly affect Silicon Valley in its capacity as the nation's premier hotbed for high tech startups and the VC funds which help to finance them.

---

[25] This latter point concerning control over a fund is due to the rule's definition of the term "sponsor," for purposes of its prohibition, to include a variety of specified control relationships between a banking entity and a hedge fund or private equity fund. Dodd-Frank Act § 619 (specifically, Bank Holding Company Act of 1956 § 13(h)(5)).

[26] FINANCIAL STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS 62 (Jan. 2011), *available at* http://www.treasury.gov/initiatives/documents/volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf ("Specifically, a number of commenters suggested that venture capital funds should be excluded from the Volcker Rule's definition of hedge funds and private equity funds…. The Council believes that the issue raised by commenters in this respect is significant. In connection with implementing an exclusion from registration for advisers solely to venture capital funds as provided under the Dodd-Frank Act, the SEC has recently proposed rules that distinguish the characteristics and activities of venture capital funds from those of other private equity funds and hedge funds. The Council recommends that Agencies carefully evaluate the range of funds and other legal vehicles that rely on the exclusions contained in section 3(c)(1) or 3(c)(7) and consider whether it is appropriate to narrow the statutory definition by rule in some cases.").

On balance, it is unlikely that the act will have a material deleterious impact on Silicon Valley and its native enterprises. Important in this regard was Congress' recognition of the fact that VC funds had not contributed to the 2008 credit crisis and should therefore not be swept into the full panoply of Advisers Act regulation to which other private funds will now generally be subjected. That being said, there are areas in which some impact will be felt, such as the proposed new SEC reporting (and potentially examination) regime with which VC funds will have to contend. Recommendations have been advanced in this article with an eye to reducing compliance cost and to ameliorating the points of friction between the new rules and the actual, customary practices of VC funds.

Perhaps the most important point to watch from a policy perspective, however, is whether the elimination of primary residences from the $1 million net worth test, along with periodic adjustments of the other fixed dollar thresholds, in the definitional standards for accredited investors will over time tangibly affect capital raising opportunities for the very youngest startup enterprises and thus potentially the pace of business formation in Silicon Valley. In this regard, only time will tell.