Investment Company Act of 1940 — Section 203(l) and rule 203(l)-1
Willkie Farr & Gallagher

September 21, 2015

RESPONSE OF THE CHIEF COUNSEL'S OFFICE
DIVISION OF INVESTMENT MANAGEMENT

IM Reference No. 20131221629

Your letter dated September 21, 2015 requests our assurance that we would not recommend enforcement action to the Commission under section 203 of the Investment Advisers Act of 1940 (the "Advisers Act") if a firm relied on the exemption from registration as an investment adviser under section 203(l) of the Advisers Act and the definition of "venture capital fund" in rule 203(l)-1 thereunder (the "Rule") under the examples described in your letter. You identify what you believe to be unintended consequences in applying the literal terms and conditions of the Rule. You provide two examples to illustrate these unintended consequences.

In Example 1, you explain that a private fund whose manager is seeking to rely on the Rule ("Relying Manager 1") makes an investment in a qualifying portfolio company, as defined in the Rule, that is not a "reporting or foreign traded" company for purposes of the Rule at the time of the investment (the "Non-Reporting Company"). You maintain that if the investment initially, or combined with a follow-on investment, causes the fund ("Relying Fund 1") to have control over the Non-Reporting Company within the meaning of the Rule, Relying Manager 1 in such a case could be deemed to have indirect control of the Non-Reporting Company by virtue of Relying Manager 1's being considered to control Relying Fund 1. If the Non-Reporting Company in this example was subsequently to conduct a public offering in the United States or abroad and was to become a reporting or foreign traded company within the meaning of the Rule (the "Qualifying Reporting Company"), the Qualifying Reporting Company would continue to be a "qualifying investment" of Relying Fund 1 for purposes of the Rule.[1] You note, however, that a detrimental effect would arise in connection with, for instance, Relying Fund 1's making an investment in a portfolio company meeting the definition of a qualifying portfolio company that provided Relying Fund 1 with control over the portfolio company (the "Second Portfolio Company"). Upon the making of that investment, you note that the Qualifying Reporting Company and the Second Portfolio Company could be considered to be under the direct common control of Relying Fund 1 and the indirect common control of Relying Manager 1. Any follow-on investment Relying Manager 1 thereafter caused Relying Fund 1 to make in the Second Portfolio Company would appear under the literal terms of the Rule to be a non-qualifying investment ("Non-Qualifying Investment") by virtue of the Second Portfolio Company's being a company under common control with the Qualifying Reporting Company.[2]

You note that the same result would occur if a second venture capital fund managed by Relying Manager 1 (the "Second Relying Fund") made a controlling investment in a portfolio company (the "Second Portfolio Company") that, considered by itself, would be a qualifying portfolio company for purposes of the Rule. In such a case, the Second Portfolio Company, after the controlling investment was made, would become a Non-Qualifying Investment of the Second Relying Fund by virtue of the Qualifying Reporting Company and the Second Portfolio Company being under the indirect common control of Relying Manager 1.[3]

In Example 2, a second manager seeking to rely on the Rule ("Relying Manager 2") causes a private fund that it advises ("Relying Fund 2") to make an investment in a portfolio company (the "Portfolio Company"). The Portfolio Company was, at the time of investment, a company under common control with a reporting or foreign traded company (the "Reporting Company") because of direct controlling interests held by a fund (the "Fund") that is advised by a manager that is not an "advisory affiliate"[4] of Relying Manager 2 or a similar entity[5] that is not an "advisory affiliate" of Relying Manager 2 and the manager or similar entity is, or is not, a

manager seeking to rely on the Rule (the "Unaffiliated Manager"). You state that, in such a case, an investment by Relying Fund 2 in the Portfolio Company, a company under common control with the Reporting Company, would appear to be a Non-Qualifying Investment not only with respect to Relying Fund 2, but also any private fund advised by any other firm seeking to rely on the Rule.[6] You also note that the same result would occur if Relying Manager 2 caused Relying Fund 2 to make an investment in any portfolio company that is under the indirect control of the Unaffiliated Manager.[7]

Background

Section 203(l) of the Advisers Act provides that a person meeting the Advisers Act's definition of "investment adviser" is exempt from registering as an investment adviser under the Act if the person acts as an investment adviser solely to one or more "venture capital funds." The Rule implements section 203(l) by defining a "venture capital fund," in part, as a "private fund"[8] that immediately after the acquisition of any asset, other than "qualifying investments" or short-term holdings, holds no more than 20 percent of the amount 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 by the fund.

Under the Rule, a "qualifying investment" is defined as, among other things, an equity security issued by a "qualifying portfolio company" that has been acquired directly by a private fund from the qualifying portfolio company.[9] Under Rule 203(l)-1(c)(4), a "qualifying portfolio company" is in turn defined to mean any company that, among other things, at the time of any investment by the private fund, is not "reporting" or "foreign traded" (a "reporting company") and does not "control," is not controlled by or under common control with another company, directly or indirectly, that is reporting or foreign traded.[10]

The "venture capital fund" definition, according to the Commission, was designed to distinguish venture capital funds from other types of private funds, such as hedge funds and private equity funds, and to address concerns expressed by Congress regarding the potential for systemic risk.[11] A Senate Committee report stated that venture capital funds may be less connected with the public markets and may involve less potential for systemic risk than large private funds whose advisers are required to register with the SEC under Title IV of the Dodd-Frank Act.[12] Accordingly, for purposes of defining a venture capital fund, the Commission excluded reporting companies, and companies that control, are controlled by, or are under common control with a reporting company, as qualifying investments unless a qualifying portfolio company becomes a reporting company subsequent to the fund's investment.[13]

Discussion

You assert that the results illustrated in Example 1, Example 1 Follow-Up, Example 2, and Example 2 Follow-Up (collectively, the "Examples") are inconsistent with the Commission's intent in adopting the terms of the Rule and its understanding of Congressional intent in enacting Section 203(l). You emphasize with respect to Example 1 that the Commission indicated that investments in qualifying portfolio companies that become reporting companies subsequent to the fund's investment would not automatically become Non-Qualifying Investments to afford a manager seeking to rely on the Rule "sufficient flexibility to exercise [the manager's] business judgment on the appropriate time to dispose of portfolio company investments"[14] and to ensure that a venture capital fund is not put in a "position of having to dispose of securities of a qualifying portfolio company that subsequently becomes a reporting company."[15] You maintain that it seems inconsistent with the Commission's approach and the policy goals underlying the Rule to provide for a venture capital fund's continuing to treat a qualifying portfolio company that becomes a reporting company--the Qualifying Reporting Company in Example 1 above--as a qualifying portfolio company, while deeming a company that has all of the requisite attributes of a qualifying portfolio company--the Second Portfolio Company in Example 1 above--to no longer have that status simply because of Relying Fund 1's direct controlling interest, or Relying Manager 1's indirect controlling interest, in the Qualifying Reporting Company. You argue that, in such a case, the Second Portfolio Company would seem no more connected with the public market than it was prior to the Qualifying Reporting Company's becoming a reporting or foreign traded company. You state that treating a follow-on investment by Relying Fund 1 in the Second Portfolio

Company as a Non-Qualifying Investment seems an unintended result because the follow-on investment is being made in a portfolio company that is an appropriate holding of, and consistent with the goals of, a traditional venture capital fund. You represent that the follow-on investment would not change the character of Relying Fund 1.

You submit that such an outcome could potentially significantly constrain the operations of the manager in managing the fund. You represent that it is consistent with the operations of a traditional venture capital fund for the fund to assume and maintain a controlling investment position in multiple portfolio companies. As a result, it would not be atypical for a venture capital fund to have investments in multiple qualifying portfolio companies that are under common control with a reporting or foreign traded company that is a qualifying portfolio company of the fund and/or the fund's manager ("Common Controlled Companies"). You indicate that a literal application of the rule text would render a venture capital fund's follow-on investment in each Common Controlled Company a Non-Qualifying Investment, a result that would seem inconsistent with the Commission's recognition generally of the importance of follow-on investments in the venture capital business[16] and, therefore, inconsistent with what the Commission seemed to have contemplated in adopting the Rule.

You also submit that Example 2 makes clear that the detrimental effect of the Rule's being read to provide that an investment by Relying Fund 2 in an entity that would be a qualifying portfolio company, if it was not under the common control of the Unaffiliated Manager with a Reporting Company (an "Unaffiliated Common Controlled Company"), is a Non-Qualifying Investment extends to any manager seeking to rely on the Rule whose fund invests, or funds invest, in an Unaffiliated Common Controlled Company. You assert that reading the Rule as having that effect would necessitate Relying Manager 2's taking into account investments made by funds managed by any Unaffiliated Manager in seeking to meet the terms and conditions of the Rule even though such Unaffiliated Common Controlled Company would seem no more connected with the public market than the Common Controlled Company. You further submit that imposing such an obligation on Relying Manager 2 would subject the manager to an administrative burden that would seem inconsistent with the Commission's goal in adopting the Rule of not unduly constraining the operations of venture capital funds. You note that in your experience, Relying Manager 2 would often be unaware of the Reporting Company or the status, if any, of the Reporting Company in the qualifying or non-qualifying basket of the Unaffiliated Manager.

In making these arguments, you distinguish the Examples from an issue raised by commenters on the proposed rule, who suggested that an adviser should not be precluded from relying on the exemption because the adviser to a private fund was controlled, or became controlled by, a reporting company.[17] The Commission made no change in the Rule in response to the commenters' concerns, suggesting that the non-qualifying basket provided sufficient relief to address the commenters' concerns that, if the adviser relied on the exemption, then any investment in a portfolio company controlled by the private fund was a Non-Qualifying Investment for purposes of the Rule.[18] You suggest that the scenario raised by the commenters is significantly different from those reflected in the Examples because, in the commenters' scenario, the portfolio company can be seen as having a substantial level of connection with a reporting company, whereas in the Examples, the reporting company and the other portfolio company are connected only by virtue of being in the portfolio of the same fund or in the portfolios of funds managed by the same adviser. You submit that the degree of connectedness in the Examples is much more attenuated than in the situations cited in the letters of commenters on the Rule as proposed and should lead to a different conclusion from that arrived at by the Commission in response to those letters. You also submit that the case cited by the commenters involves a fact pattern - an adviser's being controlled by a public company -- that is far less likely to occur than the fact patterns described in the Examples.

We agree that in certain situations, including the situations outlined in your letter, the application of the literal wording of this aspect of the Rule may have unintended consequences. Based on the facts and representations set forth in your letter, we would not recommend enforcement action to the Commission under section 203 of the Advisers Act if a firm relied on the exemption from registration as an investment adviser under section 203(l) of the Advisers Act and the definition of "venture capital fund" in the Rule if all of the requirements of the Rule are met, except that a company fails to

meet the definition of a "qualifying portfolio company" solely by reason of the circumstances set forth in the Examples. Because our position is based on the facts and representations in your letter, any different facts or representations may require a different conclusion.

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Senior Counsel

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[1] *See* rule 203(l)-1(c)(4).

[2] *See* Appendix: Example 1 of the incoming letter for a diagram of this example.

[3] *See* Appendix: Example 1 Follow-Up of the incoming letter for a diagram of this example.

[4] An "advisory affiliate" is defined for these purposes as: "(1) all of your officers, partners, or directors (or any person performing similar functions); (2) all persons directly or indirectly controlling or controlled by you; and (3) all of your current employees (other than employees performing only clerical, administrative, support or similar functions)." *See* Form ADV, Glossary of Terms.

[5] You note that such an entity might be, for instance, a family office that is excluded from the definition of "investment adviser" by virtue of section 202(a)(11)(G) of the Advisers Act.

[6] *See* Appendix: Example 2 of the incoming letter for a diagram of this example.

[7] *See* Appendix: Example 2 Follow-Up of the incoming letter for a diagram of this example.

[8] Under section 202(a)(29), a "private fund" is "an issuer that would be an investment company, as defined in section 3 of the [Investment Company Act of 1940], but for section 3(c)(1) or 3(c)(7) of that Act." *See Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers,* Advisers Act Release No. 3222 (June 22, 2011) [76 FR 39646] (July 6, 2011), n.8 ("Adopting Release") (incorporating the definition of "private fund" contained in section 202(a)(29) of the Advisers Act).

[9] Rule 203(l)-1(c)(3)(i).

[10] "Reporting," under the Rule, means, with respect to a company, that the company is subject to the reporting requirements under section 13 or section 15(d) of the Securities Exchange Act of 1934, and "foreign traded" means, with respect to a company, that the company has a security listed or traded on any exchange or organized market operating in a foreign jurisdiction. Rule 203(l)-1(c)(5). "Control" is defined in the Advisers Act to mean "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company." Section 202(a)(12) of the Advisers Act.

[11] *See* Adopting Release at 39648.

[12] *Id.* at 39656.

[13] *Id.* Otherwise, a venture capital fund may hold up to 20 percent of its aggregate capital contributions and uncalled committed capital in assets that are Non-Qualifying Investments, including reporting company holdings. The 20 percent limit was intended to balance commenters' expressed desire for greater flexibility to accommodate existing business practices while providing sufficient limits on the extent of investments that would implicate Congressional statements regarding the interconnectedness of venture capital funds with the public markets. See Adopting Release at section II.A.3.a.

[14] *See id* at 39657.

[15] *See id.*

[16] *See id* at 39658.

[17] *See id* at 39656 n.160.

[18] *See id.* at 39656.

Incoming Letter

The Incoming Letter is in Acrobat format.

http://www.sec.gov/divisions/investment/noaction/2015/wilkie-farr-gallagher-092115-203.htm

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