Congress Grants Increased Flexibility for Small Venture Funds and Small Public Companies with Passage of the Economic Growth, Regulatory Relief, and Consumer Protection Act

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On May 24, 2018, President Trump signed into law the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Reform Act") which includes federal securities law and regulation reforms for privately held, high-growth companies, venture capital funds, and public reporting companies. The amendments include (1) an amendment to the Investment Company Act of 1940 (the "1940 Act") exempting certain small venture capital funds with no more than 250 investors from registering under such Act, (2) a change to Rule 701 raising the disclosure limit to $10 million in any twelve-month period, and (3) a revision of Regulation A allowing public reporting companies to take advantage of the exemption allowed under the title. These changes are discussed in more detail below.

- **Investment Company Act of 1940**
  - **Background**: Section 3(c)(1) of the Investment Company Act of 1940 allows privately offered funds, including venture capital funds, with no more than 100 investors to avoid increased regulatory burdens associated with registering as an investment company under the 1940 Act. For small venture capital funds, this 100-investor limit was a significant regulatory burden limiting the total size of venture capital funds that could not rely on other 1940 Act's other exemptions, including Section 3(c)(7) exemption for funds that do not make public offerings and who only sell to "qualified investors" (generally, individuals with at least $5 million in "investments" or entities with at least $25 million in "investments" as defined by the SEC).
  - **Amendment**: The Economic Growth Act amends Section 3(c)(1) by raising the 100 investor limit to 250 investors before a venture capital fund would be required to register as an investment company under the 1940

Act. However, the fund must (1) have, at all times, less than $10 million in aggregate capital contributions and uncalled committed capital, and (2) meet the definition of a venture capital fund as defined in the Investment Advisers Act of 1940. A venture capital fund is generally defined in the Investment Advisers Act as the fund that: (i) would be an investment company but for the exceptions provided under Sections 3(c)(1) or 3(c)(7) of the 1940 Act, (ii) represents to investors that it pursues a venture capital strategy, (iii) invests predominantly in private operating companies and (iv) employs a limited amount of leverage. The $10 million limit, which includes not only the aggregate capital contributions but also the uncalled commitments, will be adjusted every five years to account for inflation. This change will allow small venture capital fund managers more flexibility in structuring their funds, potentially also reducing some of the need for side-by-side fund structures that managers often used when the 100-investor limit was in place under Section 3(c)(1) to create a parallel fund for qualified investors under Section 3(c)(7). However, even when accepting up to 250 investors, venture capital fund sponsors should be aware that if they were to go above the new monetary limit set forth in section 3(c)(1), they will not be able to rely on this new exemption. This amendment is immediate in its effects and does not similarly apply to funds other than venture capital funds (e.g., private equity funds or hedge funds) which remain subject to a 100-investor limit when relying on Section 3(c)(1) exemption under the 1940 Act. In addition, funds that rely solely on this amended exemption, however, would still be considered "covered funds" for purposes of the Volcker Rule, which would continue to limit banking entities' ability to invest in such funds.

- **Rule 701**

- **Background**: Rule 701 is an exemption from the registration requirements under the Securities Act of 1933 for the issuance of securities to employees, directors, and certain consultants available only to private companies. The Rule 701 requires securities to be granted or sold under a written compensatory benefit plan and also that the value of such securities at the time of issuance in any twelve-month period does not exceed the greater of (1) $1 million, (2) 15% of the issuer's total assets, or (3) 15% of the issued securities of the same class being offered, not including those offered under Rule 701, in each case (2) and (3) as measured by the most recent balance sheet date. If sales exceed $5 million in any twelve-month period, the company is subject to heightened disclosure requirements for all securities, including those issued before the threshold was met.
- **Amendment**: The Reform Act raises the bar for enhanced disclosure requirements to $10 million in any twelve-month period. Now, if a company meets or exceeds this threshold, it must provide recipients of its securities with (1) a summary of the material terms of the compensatory plan, (2) information about the risks associated with applicable securities (similar to the risk information contained in a private placement memorandum), and (3) financial statements complying with Generally Accepted Accounting Principles within 180 days of the date of issuance or sale of the securities. The effects of this change, however, will not be felt immediately, as the SEC must first amend Rule 701 as directed by the Act within 60 days of enactment. Interested parties should await these specific changes for further detail.

- **Regulation A**
  - **Background**: Regulation A granted an exemption from registration requirements under the securities act to certain *private companies*

allowing them to raise up to $50 million in a twelve-month period. It gave such companies significant regulatory reprieve by allowing them to file a smaller Form 1-A with the SEC instead of the much longer and more thorough Form S-1 required under the traditional IPO process. Regulation A provides for two types of offerings: Tier 1 permitting up to $20 million in a twelve-month period, and Tier 2 permitting up to $50 million in the same period but requiring issuers to meet ongoing periodic reporting obligations. Tier 2 offerings have an advantage, however, of preempting state securities registration requirements (often called Blue Sky Laws). In addition, securities sold under Regulation A are not considered to be "restricted" under Securities Act Rule 144 and thus can generally be sold to any investor and resold at will.

- **Amendment**: The Act mandates that the SEC amend Regulation A to allow public reporting companies to qualify for the same exemption for securities offerings that is given to certain private companies. Once the SEC revises the Regulation, such reporting companies can make offerings under Regulation A, and those making offerings under Tier 2 will be presumed to have satisfied periodic disclosure requirements if they have satisfied their periodic disclosure obligations under the Securities Exchange Act of 1934. This change mainly benefits small public companies, as the disclosures mandated by Regulation A are less complex and less costly and may allow such companies to avoid complying with Blue Sky Laws. Like the change to Rule 701, interested parties should be on the lookout for the SEC's amendments in the coming months.

Overall, the changes to the Investment Company Act, Rule 701, and Regulation A are intended to create additional liquidity mechanisms for venture funds, private companies, and public reporting companies. These additional mechanisms should allow such entities some additional flexibility to better manage their growth and securities portfolios, meeting their needs as they see fit.

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