Blogs
April 04, 2016
Asset Management ADVocate

SEC Staff Puts a Bow on Gifts from Christmas 2015 Legislation

Late last fall, Congress faced a serious crisis in trying to pass a comprehensive transportation bill, designated as the Fixing America's Surface Transportation (FAST) Act. Amendments to various Federal securities and banking laws were added to the FAST Act during the reconciliation process. These amendments had not been the subjects of serious hearings in either house of Congress and were such narrow, rifle-shot changes as to deserve to be considered special pleading. Some commentary has already been published regarding amendments to the Securities Act of 1933, which included codification in Section 4(a)(7) of what had been previously referred to as the Section 4(1½) exemption: a long-standing interpretation permitting the resale of unregistered securities to sophisticated investors without causing the seller to be an underwriter. Certain Silicon Valley investors apparently considered Section 4(1½) too delimiting, leading to the statutory changes that should facilitate greater liquidity for those investors, hopefully making it easier for early state start-ups to raise additional capital. The FAST Act also amended two provisions of the Investment Advisers Act of 1940 ("Advisers Act"). Readers will recall that the Dodd-Frank Act included exemptions from SEC registration for venture capital advisers, family offices and certain hedge fund advisers. The SEC promptly adopted regulations to implement these exemptions. Section 203(l) exempts investment advisers whose only clients were one or more "venture capital funds" as defined in Rule 203(l)-1. Rule 203(m)-1 exempts investment advisers solely to private funds that had assets under management in the United States of less than $150 million. The Dodd-Frank Act also added an exemption for advisers to small business investment companies ("SBICs") in Section 203(b)(7) of the Advisers Act. This exemption requires advisers to manage only SBICs. The FAST Act breaks down the barriers between advisers to venture capital funds or private funds and SBICs by including SBICs in the definition of venture capital funds and excluding SBIC assets from the $150 million limit on private funds. As a result, managers of SBICs can now rely on Section 203(l) or (m) to expand into venture capital funds or hedge funds without registering with the SEC, and managers of venture capital funds and private funds can add SBICs without risking their exemptions. However, an adviser still could not advise all three types of funds under these exemptions. In IM Guidance Update 2016-3 (March 2016), the SEC staff expressed its view that an investment adviser currently relying on Section 203(b)(7) may: (1) rely on Section 203(l) and advise both SBICs and qualifying venture capital funds; or (2) rely on Section 203(m) and advise both SBICs and non-SBIC private funds, provided those non-SBIC private funds account for less than $150 million in assets under management. The SEC staff noted, however, that an investment adviser to an SBIC that chooses to rely on either Section 203(l) or (m) is required to submit reports to the SEC as an exempt reporting adviser. There is additional commentary in IM Guidance Update 2016-3 that an adviser thinking of relying on these expanded exemptions should read. The exemption for investment advisers to venture capital funds, like the exemptions for business development companies in the Advisers Act and in the Investment Company Act of 1940 upon which it is modeled, was based on the policy that it was in the public interest to adjust the laws that would otherwise apply where the investments were being made directly in early stage start-ups—entities that are generally unable to have access to traditional forms of financing from commercial lenders or the public stock exchanges. These new provisions in the FAST Act are consistent with that public policy judgment. What is truly remarkable is that these relatively important exceptions from the laws that apply to all holders of restricted securities and to investment advisers to SBICs were added to the FAST Act, without the usual vetting that comes with public hearings, by exceptionally skilled advocates who are plainly highly sophisticated in the manner in which legislation can be enacted.

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