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# The Dodd-Frank Act and Foreign Venture Capitalists

By Joseph R. Magnas

Israeli companies have been spared most of the effects of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Israeli companies that are traded in the United States may be subject to some of the act's corporate governance provisions, but even those will apply only to companies that are not foreign private issuers or otherwise elect to follow the U.S. proxy rules.

However, private funds may be affected by the Dodd-Frank Act. Among other things, the Dodd-Frank Act repealed the private advisers' exemption of the 1940 Investment Advisers Act (the "Advisers Act"). Prior to the repeal, advisers who met certain conditions were exempt from the onerous registration and record-keeping requirements of the Advisers Act and were not subject to examination by the SEC staff. The Dodd-Frank Act repealed the private fund adviser exemption, thus subjecting more advisers to registration. The act provides limited exemptions from registration for advisers to venture capital funds and certain private funds. In addition, the Dodd-Frank Act provides that the Advisers Act will not apply to any foreign private adviser.

In June 2011, the SEC adopted rules that define the terms "venture capital fund" and "foreign private adviser." Under the new rule, a VC fund may not hold more than 20% of its capital commitments in non-qualifying investments, other than short-term holdings. Qualifying investments generally include equity securities issued by a qualifying portfolio company.

A qualifying portfolio company is defined in the rule as any company that (i) is not a reporting company or foreign traded company; (ii) does not incur leverage in connection with the investment by private fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment; and (iii) is not itself a fund.

Venture capital fund advisers generally will want to remain exempt under the Advisers Act and, accordingly, make sure that their funds meet the definition of a “venture capital fund” under the rule. What are those non-qualifying investments that advisers will need to avoid or at least limit? Investments in public companies, both U.S. and foreign, are non-qualifying investments. Likewise, the purchase of securities from a shareholder of an issuer as opposed to a direct investment is a non-qualifying investment.

U.S. venture capital funds have become regular participants in PIPE transactions and other transactions involving small, publicly traded companies. Limiting the ability of VC funds to participate in transactions with publicly traded companies will adversely affect the business models of some funds. It also diminishes the pool of potential investors for smaller companies.

The limitation on secondary purchases limits venture capitalists from taking advantage of a number of situations in which it may be in their best interest to purchase shares held by existing holders of a company. For example, advisers to VC funds may look to buy out existing shareholders of a company that have a redemption right or otherwise need or want to exit their investment. Such transactions are not common. However, any fund that enters into any such transaction may use up a good portion of its 20% limit on non-qualifying investments. Limiting the ability of VC funds to participate in non-qualifying investments will decrease the pool of potential investors for such transactions. This will adversely affect the business models of some funds and may have an adverse effect on the valuation of

the transactions.

Foreign venture advisers must be careful that they do not trigger the U.S. registration requirements. Under the rule, a "foreign private adviser" is any investment adviser that (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients in the U.S. and investors in the U.S. in private funds advised by the adviser; (iii) has aggregate assets under management attributable to clients in the U.S. and investors in the U. S. in private funds advised by the investment adviser of less than $25 million; and (iv) does not hold itself out generally to the public in the U. S. as an investment adviser.

Many foreign VC funds have U.S. clients and will need to consider the proposed rules to the same extent as their counterparts in the U.S. On the other hand, advisers who meet the definition will have greater flexibility with respect to fund structure and investments than their U.S. counterparts.

The new rule will go into effect on March 30, 2012. In addition, many VC funds will be able to take advantage of grandfather clauses rather than change their existing business models. Since the adoption of the new rule, a number of venture capitalists have stated that they believe the 20% limitation will not adversely affect their business models. However, until the rule goes into effect and we have an opportunity to study the changes in the U.S. venture capital market, it is difficult to assess the full impact of the changes.

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