V Venture capital (VC) funds are sources of startup financing for early-stage, high-growth firms, such as technology startups. According to the Securities and Exchange Commission (SEC), as of the second quarter of 2022, more than 2,000 VC funds were managing about $330 billion in assets. Although the size of VC investments appears small compared to the overall size of U.S. capital markets (which exceeds $100 trillion) the industry nonetheless plays a key role in funding entrepreneurs that carry out innovations. These startups form the pipeline for potentially transformative companies that could become drivers of economic growth. Many well-known publicly traded technology companies—such as Alphabet (Google’s parent company), Apple, Meta, and Amazon—were once VC funded. This In Focus explains VC operations, regulatory frameworks, and policy proposals.

**Startup Funding Cycle**

Figure 1 illustrates the typical stages of a startup funding cycle. VC funds could participate in all stages of a cycle but generally focus on earlier to middle stages. Depending on a startup’s specific development phase, the firm’s funding needs and financing sources could differ. A startup’s development stage is typically measured by revenue growth, time in existence, and product maturity, among other factors. In general, the later the stage, the larger the startup’s size and funding needs.

![Figure 1. Startup Funding Cycle](image)

**Notes:** A stylized graphical depiction of a startup funding cycle and startup company growth line.

**Pre-seed stage.** At this early stage, the startup has gone through concept formation but has typically not yet commenced business operations or sold products. “Self, family, and friends” (SFF, also called “bootstrapping”) and angel investors (e.g., accredited investors, see CRS In Focus IF11278, *Accredited Investor Definition and Private Securities Markets*) typically provide major sources of funding.

**Seed stage.** During the seed stage, startups have developed initial business operations, including operational readiness for products or product prototypes. But the business typically remains pre-revenue. Early VC, SFF, and angel investors are common sources of funding at this stage.

**Series A.** This is generally the first round where VC becomes the dominant source of funding. A startup at this stage has generally developed marketable products and a customer base. This is also the stage when startups have developed their business plans and started to proactively approach different institutional investors for fundraising.

**Series B.** During a Series B funding round, VC investors usually focus on the acceleration of business expansion and commercialization of the products. Series B round startups are relatively established and have begun to achieve more substantial performance milestones.

**Series C.** Late-stage VC and other institutional investors (including private equity firms, investment banks, and hedge funds) provide series C funding to more mature companies. Series C funding helps startups to further expand their products and markets. A startup at this stage has ordinarily demonstrated strong growth, a trajectory toward profitability, and a customer base.

**Mezzanine.** This is the last stage of VC involvement before a final exit to sell their investment positions for cash. Startups at this stage have matured and are ready to be acquired or become publicly traded.

**Exit.** Most VCs aspire to exit their investments via initial public offerings (IPOs). At this stage, the startup could issue securities to the public. But other forms of exit also exist, including sales to other corporations or private funds. A startup could also merge with a special purpose acquisition company (see CRS In Focus IF11655, *SPAC IPO: Background and Policy Issues*) at this stage.

**Business Models and Practices**

VC investors assume high risks in the hopes of making high returns. VC firms often have several dozen startup companies in their portfolios and are actively involved in their operations. While some of these portfolio companies may fail, VC investors can still reap substantial rewards if some surviving portfolio companies achieve major success (e.g., receive 5, 10, or 20 times the initial investment). VCs have varying levels of size, expertise, and depth of financial strength. Different VCs may show different preferences for a particular industry segment or startup development stage. VCs are often associated with high innovation and performance. An academic study of IPOs, shows that VC-backed IPOs outperformed other IPOs in key financial...
measures (Table 1). However, VC firms and VC-backed companies are highly concentrated in three metropolitan areas—the San Francisco Bay Area, New York, and Boston. VC investments are also concentrated in certain relatively narrow technological innovations.

### Table 1. Relative Performance of VC-Backed IPOs (1995-2019)

<table>
<thead>
<tr>
<th></th>
<th>VC-Backed IPOs</th>
<th>All IPOs</th>
<th>VC-Backed as a % of All</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of non-</td>
<td>1,930</td>
<td>4,109</td>
<td>47.0%</td>
</tr>
<tr>
<td>financial IPOs (1995-2019)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of firms still public at 12/31/2019</td>
<td>582</td>
<td>1,044</td>
<td>55.7%</td>
</tr>
<tr>
<td>Share of IPOs that were still public at 12/31/2019</td>
<td>30%</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>Total enterprise value ($billions)</td>
<td>$4,845</td>
<td>$7,130</td>
<td>67.9%</td>
</tr>
<tr>
<td>Total market capitalization ($billions)</td>
<td>$4,922</td>
<td>$6,462</td>
<td>76.2%</td>
</tr>
<tr>
<td>Research and development expenditure ($billions)</td>
<td>$148</td>
<td>$167</td>
<td>88.6%</td>
</tr>
</tbody>
</table>


**Regulatory Frameworks**

While VC funds and VC advisers are generally subject to regulations applicable to investment funds and advisers, they can qualify for exemptions by meeting various criteria.

**VC Fund Regulation Exemptions**

In general, funds that invest in businesses on behalf of the funds’ investors face regulation pursuant to the Investment Company Act of 1940 (ICA; P.L. 76-768). However, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203), the SEC established a legal definition for venture capital funds for the first time in 2011 and established exemptions from certain ICA regulatory requirements. To be deemed venture capital and receive related exemptions, the fund must generally meet the following conditions: (1) represents itself as pursuing a venture capital strategy to its investors and prospective investors; (2) holds no more than 20% of its aggregate capital contributions and uncalled committed capital in non-qualifying investments other than short-term holdings; (3) does not borrow, provide guarantees, or otherwise incur leverage other than limited short-term borrowing; (4) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; and (5) is not registered under the ICA and has not elected to be treated as a business development company. Qualifying investments (QIs) generally consist of direct equity investments in qualifying portfolio companies. Secondary transactions (i.e., the selling of existing shares), fund of funds (i.e., a fund that invests in other funds), pure debt instruments, public issuance, and some digital assets are generally not QIs.

To be exempt from ICA, a VC fund must also be owned by 250 or fewer persons and must have $10 million or less in aggregate capital contributions and uncalled committed capital (i.e., capital not yet disbursed). Qualifying VC funds are exempt from the ICA and are not required to register with the SEC and provide related disclosure and compliance at the fund level. In addition, VC funds may use other exemptions that are not limited to VC funds specifically but could also provide exemption to registration under the ICA. For example, under Sections 3(c)(1) and 3(c)(7) of the ICA, funds are exempt from ICA if they meet certain requirements, such as ownership and purchaser restrictions.

**VC Adviser Regulation**

Investment advisers, including VC advisers, could be subject to regulation prescribed in the Investment Advisers Act of 1940 (ICA; P.L. 76-768). Section 202(a)(11) of the IAA defines adviser as any person or firm that, for compensation, is engaged in providing advice to others or issuing reports or analyses regarding securities. VC fund managers could qualify as advisers and be subject to related SEC registration and oversight or seek exemption from registration. Rule 203(1) of the IAA provides an exemption for VC advisers who are solely advising VC funds. These advisers are considered exempt reporting advisers (ERAs). ERAs are not subject to the same federal or state registration procedures as other SEC-registered investment advisers but must still register with and report to securities regulators and satisfy certain compliance requirements. For example, ERAs must file parts of Form ADV with the SEC and state securities authorities. These Form ADV disclosures are publicly available, including information about the adviser’s business, ownership, employees, affiliations, fund size, and past disciplinary events, among other information. Similar to other registered investment advisers, ERAs must also meet other compliance requirements, including fiduciary, anti-fraud, anti-money laundering, and investor privacy protection requirements.

**Policy Proposals**

Some legislative proposals aim to expand capital formation under VC funds by expanding the related legal definitions that provide exemptions. The Developing and Empowering our Aspiring Leaders Act of 2023 (H.R. 2790) proposes to change the definition of QIs to include certain secondary transactions and fund of funds. The proposal would address the concern that VC funds are increasingly challenged by the 20% limit of non-qualifying investments. Some VC advocates argue that the limit often causes VCs to forgo general investment opportunities. But some investor advocates are concerned that by permitting an expanded VC fund investment presence in secondary market shares, VCs could shift fund activity away from direct primary investment stakes in startups. The Improving Capital Allocation for Newcomers Act of 2021 (H.R. 2790) proposes to raise the persons and committed capital thresholds for VC qualification requirements, thus increasing the number of funds that could potentially use the VC exemption. Title III and Title VI of the Expanding Access to Capital Act of 2023 (H.R. 2799) also contain related VC proposals.

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