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# Venture Capital Funds: Proposals to Expand Investor Thresholds Required for Registration (Section 504 of S. 2155, Section 471 of H.R. 10, H.R. 1219, S. 444, and Section 914 of H.R. 3280)

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Introduction

To help restore confidence in the securities markets after the stock market crash of 1929, Congress passed the Securities Exchange Act of 1934, which authorized the creation of the Securities and Exchange Commission (SEC). The SEC is an independent, nonpartisan regulatory agency responsible for administering federal securities laws. It has broad regulatory authority over significant parts of the securities industry, including stock exchanges, mutual funds, investment advisers, and brokerage firms.

Among the major federal securities statutes that the SEC enforces is the Investment Company Act of 1940 (ICA; P.L. 76-768). According to the SEC, the ICA applies to investment companies, and investment vehicles (such as mutual funds) that are "engaged primarily, … or proposes to engage primarily, in the business of investing, reinvesting or trading in securities, or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40% of the value of [i]ts total assets…." The SEC has described the ICA as designed to minimize conflicts of interest that arise in these complex operations. The act requires these companies to disclose their financial condition and investment policies to investors when stock is initially sold and, subsequently, on a regular basis. The ICA's focus is on disclosure to the investing public of information about a given fund and its investment objectives, as well as on the investment company's structure and operations.

The ICA excludes certain investment pools, including hedge funds, from the definition of investment company, exempting them from registration under and compliance with the act if they have certain characteristics. One such characteristic is when a pooled investment entity has outstanding stock that is owned by 100 or fewer beneficial owners (a beneficial owner is a person who enjoys the benefits of ownership even when the title to a security is in another person's name such as a broker-dealer who is acting on behalf of an investor). Under the ICA, if a pooled investment takes on its 101st beneficial owner, it must register as an investment company and start to incur the potentially significant time and money costs associated with that registration.

Organized and run by their general partners, venture capital funds are investment pools that manage the funds of their wealthy investors interested in acquiring private equity stakes in emerging small- and medium-sized firms and startup firms with perceived growth potential. The funds often take an active role in the businesses, including providing managerial guidance and occupying corporate board seats. Venture capital funds with 100 or fewer beneficial owners are also not defined as investment companies, exempting them from the ICA registration requirement.

Recent Legislation

Currently, there are concerns within the business community over the perceived behavioral impact of the 100-investor limit on venture capital funds. Some observers have said that to avoid ICA registration and its potentially significant money and time costs, some venture capital funds appear to be reluctant to add additional investors, a potential loss of opportunities to expand the capital that they might use to invest in and help grow various businesses, which has historically included high-tech firms for some funds.

A number of proposals related to this issue have seen floor or committee action in the 115th Congress:

- Section 504 of S. 2155, which has passed the Senate;
- H.R. 1219, Supporting America's Innovators, which has passed the House;
- S. 444, Supporting America's Innovators, which has been marked up by the Senate Committee on Banking, Housing, and Urban Affairs;
- Section 471 of H.R. 10, the Financial CHOICE Act, which has passed the House; and
- Section 914 of H.R. 3280, the Financial Services and General Government Appropriations Act, 2018, which has been marked up by the House Committee on Appropriations.

H.R. 1219, S. 444, and Section 504 of S. 2155 would amend the ICA by creating a new subset of venture capital fund called a *qualifying venture capital fund* (QVCF). QVCFs would be venture capital funds (as defined in federal securities law) with no more than $10 million in invested capital that could be owned by up to 250 beneficial investors (from the current 100) before triggering the ICA registration requirement. Somewhat differently, Section 471 of H.R. 10 and Section 914 of H.R. 3280 would both amend the ICA by creating a QVCF, a venture capital fund (as defined in federal securities law) with up to $50 million in invested capital that could be owned by up to 500 beneficial investors (from the current 100).

Proponents of the bills have argued that they would generally help to broaden access to capital for small businesses, thus boosting their prospects to thrive. H.R. 1219's and S. 444's sponsors, Representative Patrick McHenry and Senator Heidi Heitkamp, respectively, have also spoken of added benefits: They argue that the legislation would be particularly helpful at expanding the number of venture capital funds in rural areas, thus helping to nurture more rural startups and small businesses.

By contrast, the North American Securities Administrators Association (NASAA), a group of state and provincial securities regulators, examined similar legislation, an early version of H.R. 4854, which passed the House in the 114th Congress. That bill would have expanded the beneficial investor cap to 250 investors (as would S. 2155, S. 444 and H.R. 1219 in the 115th Congress). After the examination, a key NASAA concern was that by broadening existing regulatory exemptions, the legislation would problematically expand the universe of investment vehicles devoid of regulatory oversight to the detriment of fund investors.