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Proposed Federal Legislation Could Further Imperil Start-Up Financing

September 15, 2009

Venture capital financing of start-ups, already at a low point in this recession, could decrease even further if proposed federal legislation is enacted to regulate private pools of investment capital. Proposed bills would require venture capital funds to register with the Securities and Exchange Commission in an effort by the government to shed light on fundraising and operations in hopes of curtailing abuses by other private equity funds such as those that deal in mortgage-backed securities, derivatives, highly leveraged transactions and a host of complex instruments. SEC registration of funds would expose the funds' financial records to scrutiny, both governmental and otherwise, to try to limit damage to the nation's financial system. Venture capital funds appear to be caught in a widely-cast net. Senators Grassley and Levin introduced Senate Bill No. 344 on January 29, 2009 designed to require hedge funds to register with the SEC, naming the act the Hedge Fund Transparency Act. However a new limitation on the existing exemption from the reach of the Investment Company Act of 1940 includes not only hedge funds but all investment companies with assets under management of over $50 million only if they register with the SEC, file an "information form" with the SEC, maintain such books and records as the SEC may require, and cooperate with requests for information and examination by the SEC. The "information form" is to be filed annually and include contact information of the investment companies' investors, which the SEC shall make available to the public. Senator Reed introduced Senate Bill No. 1276 on June 16, 2009 designed to require investment advisers to venture capital funds, among other funds, to register with the SEC, naming the act the Private Fund Transparency Act. However a new expansion of the reach of the Investment Advisers Act of 1940 provides that the records of any investment company to which an investment adviser provides investment advice shall be deemed to be the records of the investment adviser, and therefore be subject to disclosure. Venture capital funds pose no significant risks to our financial system. They comprise funds generated privately from wealthy investors, some individual but most institutional. The pooled funds are invested in start-ups, including pre-revenue companies, the class of companies that leads the country in job creation and that keeps the U.S. in the upper tier in biotech, infotech, medtech, agritech, cleantech, etc. Investments often remain with the fortunate

“portfolio” companies for up to 10 years, a far lengthier risk tolerance horizon than most investment vehicles, allowing innovation and entrepreneurship to flourish free from a push for short-term results. The risk of financial loss is generally self-contained, with the public and the financial system unaffected. Because venture capital funds do not leverage their investments with debt, the banking system plays no role in the entrepreneurial ecosystem other than as a repository for the invested cash and the revenues some portfolio companies generate. Under the current regulatory scheme, venture capital funds’ investments are reported to the SEC under Regulation D, the commonly-used exemption from SEC registration for private placements of securities. In this manner, the federal government is able to track an industry with less than $200 billion in deployed funds that invests less than 0.2 percent of the gross domestic product. Passage of the Sarbanes-Oxley Act of 2002 followed promptly (some say too promptly) on the heels of the Enron, Worldcom and other corporate governance failures. As is the case with most legislation which is rushed to enactment, it has had unintended consequences, both good and bad. Although Sarbanes-Oxley was intended to curb accounting abuses especially those at large public companies, SOX seems to have had the unintended consequence of imposing burdensome accounting rules on young public companies, and the mere "threat" of this probably has deterred would-be public companies. This, in turn, has reduced the market for initial public offerings, and further curtailed venture capital financings, all drying up expansion capital. While the ultimate cost/benefit analysis is yet to be done with respect to SOX, because of the substantially lessor resources available to smaller reporting companies, the costs of compliance in terms of extra labor, audit and consulting expenses clearly has resulted in a greater burden on the smaller public companies. Before enacting any new legislation relating to hedge fund disclosures, Congress should carefully consider the possible negative effects that it may have upon the availability of capital, especially to the extent that it would subject to public disclosure information about the investors and their investments in venture capital funds and the investments made by venture capital funds. Venture capital funds can be easily distinguished from the class of pooled investment funds truly in need of monitoring and consideration should be given to exempting them from such legislation. In fact, we would hope that Congress would stimulate the formation of venture capital funds and the investment of those funds to promote innovation and entrepreneurship. Last year, venture-backed companies that went public in previous years accounted for 12.1 million jobs and $2.9 trillion in revenues for the U.S. Treasury. Not bad. For more information, contact any of the Carlton Fields attorneys in the firm’s Private Equity and Venture Capital section of its Corporate, Securities and Tax Practice Group.

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