**JOBS Act 3.0/RIA VC Exemption Deal Language and Explanation**

Our agreement on modifying the VC exemption definition for purposes of RIA, noted below and written into the DEAL Act sponsored by Rep. Trey Hollingsworth (R-IN), just passed the House Financial Services Committee by voice vote.  We were pleased to see this level of support, and hope that this could give the bill momentum to pass the full House of Representatives this year.  It’s not likely it will be able to pass the Senate this year, and we still think that the SEC is the most likely route for action, but more activity will help our efforts.

**How it Would Work:**

While quite complex, this amendment would provide significant relief on secondaries for a broad range of firms dealing with the issue.  The amendment would allow private secondary investments to become qualifying investments, but requires *“that a venture fund’s qualifying investments are still predominantly qualifying investments that were acquired directly from the portfolio company.”* In other words, secondary shares acquired by VC funds would be qualifying so long as the amount of qualifying direct investments on the fund’s books are somewhat greater than their qualifying secondary investments.  One important element to the agreement is that if you violate the “predominant formula” (chart with examples and step-by-step formula below), only the overage of secondaries will spill into your nonqualifying basket.  It is not an all or nothing proposition which expands relief as you can see below.

The SEC will have to define what predominant means before we know exactly how the formula would work.  But for purposes of the illustrations below, we will assume that predominant means 70% of your total qualifying investments must be direct investments. 

This language identifies the denominator as “qualifying investments (meaning total private direct/secondary investments)” and the numerator as direct qualifying investments.  This means that any fund with less than 70% of their total private direct/secondary investments being direct qualifying investments would see the amount of secondaries that push the ratio too low go into their nonqualifying basket.  For example, if I invest $6 in direct investments and $4 in secondaries, $1.50 of those secondaries become nonqualifying investments.

Below are a number of different scenarios of how this would play out.  The illustrations assume a fund with 100 in total capital commitments, so a nonqualifying basket of 20.

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| A | Total Investments | 80 | 80 | 80 | 80 | 80 | 80 | 80 | 80 | 80 |
| B | Secondaries | 10 | 15 | 30 | 17.5 | 20 | 16 | 21 | 30 | 35 |
| C | Other non-qualifying | 10 | 15 | 5 | 17.5 | 15 | 19 | 19 | 10 | 50 |
| D | Total private direct/secondary investments | 70 | 65 | 75 | 62.5 | 65 | 61 | 61 | 70 | 750 |
| E | Direct qualifying investments | 60 | 50 | 45 | 45 | 45 | 45 | 40 | 40 | 400 |
| F | Overage that goes into nonqualifying basket | 0 | 0 | 11 | 0 | 1 | 0 | 4 | 13 | 180 |
| G | Status (nonqualifying %) | ERA (10%) | ERA (15%) | ERA (16%) | ERA (17.5%) | ERA (16%) | ERA (19%) | RIA (23%) | RIA (23%) | RIA (23%) |

To determine status as an ERA or RIA (row G) and non-qualifying percentage under this language, the below formula must be completed to determine if your direct investments are “predominant”:

1. Row E ÷ Row D = X
2. Is X above 70%?
   1. If yes, simply use non-qualifying investment percentage (Row C), to determine status as an ERA or RIA in row G.
   2. If no, decrease the denominator (Row D) by one and calculate Row E ÷ Row D = X. Continue to decrease denominator by one until X equals 70%.
      1. Subtract denominator used above from original Row D = Row F (overage that goes into non qualifying basket).
      2. Add Row F to Row C = Row G
         1. If Row G is less than 20%, ERA status
         2. If Row G is greater than 20%, RIA status

We understand this is a complex formula, but the bottom line is for funds dealing with secondaries challenges, this bill will provide relief.

**What Does This Deal Mean for Success?**

We are still very early on in the process, and we continue to believe that the SEC is our most likely path to success.  But, having a strong bipartisan vote on making secondaries a qualifying investment provides us several benefits: 1) it shows the SEC there is significant concern about the issue and suggests that they should prioritize a rulemaking on the VC definition, and 2) if this doesn’t work, with a strong bipartisan vote we have a chance to get this signed into law in 2019, which would then require SEC action.  We still have a long way to go for success on this issue, but this is an important step in highlighting in Washington the significant challenges currently faced by many VCs due to the limits of the definition.

**Shortcomings:**

We had to give up the public Emerging Growth Company (EGC) investments side of our proposal, which disproportionately impacts our biotech members.  Democrats and ILPA were strongly opposed, and over the weekend it became clear that losing this aspect of the proposal was the only way to move forward.  We also have a formula which is quite complex and takes even industry veterans several passes before the mechanics become apparent.  Finally, the term “predominantly” is not defined, so we will still have to work on that.

**Next Steps:**

The Financial Services Committee was supposed to vote on this bill on Thursday, but unfortunately that markup had to be postponed.  We are now looking at a committee vote sometime after the week of July 4th.  With this deal, unless there is an unexpected change, we expect a strong bipartisan vote with a chance that it could be unanimous.  The next step following committee passage would be passage through the House floor which could also come in July.  A strong bipartisan vote in the committee should put us in good position for a positive vote on the House floor.

Given how the Senate operates, it’s not likely to get through the Senate before Congress adjourns for the elections.  So this would become an issue for Congress to revisit next year.  Our short-term goal continues to be SEC action and including the issue on the agency’s 2019 agenda.

We are still finalizing our official proposal letter to the SEC, and in a bit of a holding pattern while this part of the process plays out.  But we expect that letter to get out in a similar timeframe as the vote in the House Financial Services Committee.  The letter will lay out our full proposal, including:

* Making fund of funds investments in other VC funds qualifying,
* Making certain cryptocurrency investments qualifying, and
* Providing some relief on the timing of capital call lines of credit.

We’re hoping that a strong vote in the House will make for a more receptive atmosphere for our official letter, and will head back to the SEC in the fall to discuss the proposal and developments.

We understand this is a rather complex formula.  Please let me know if you have any questions, and don’t hesitate to reach out to Charlotte or I anytime.