

DEVELOPING AND EMPOWERING OUR ASPIRING LEADERS  
ACT OF 2018

---

AUGUST 3, 2018.—Committed to the Committee of the Whole House on the State  
of the Union and ordered to be printed

---

Mr. HENSARLING, from the Committee on Financial Services,  
submitted the following

R E P O R T

[To accompany H.R. 6177]

[Including cost estimate of the Congressional Budget Office]

The Committee on Financial Services, to whom was referred the bill (H.R. 6177) to require the Securities and Exchange Commission to revise the definitions of a qualifying portfolio company and a qualifying investment to include an emerging growth company and the equity securities of an emerging growth company, respectively, for purposes of the exemption from registration for venture capital fund advisers under the Investment Advisers Act of 1940, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Strike all after the enacting clause and insert the following:

**SECTION 1. SHORT TITLE.**

This Act may be cited as the “Developing and Empowering our Aspiring Leaders Act of 2018”.

**SEC. 2. DEFINITIONS.**

Not later than the end of the 180-day period beginning on the date of the enactment of this Act, the Securities and Exchange Commission shall—

(1) revise the definition of a qualifying investment under paragraph (c) of section 275.203(1)–1 of title 17, Code of Federal Regulations, to include an equity security issued by a qualifying portfolio company, whether acquired directly from the company or in a secondary acquisition; and

(2) revise paragraph (a) of such section to require, as a condition of a private fund qualifying as a venture capital fund under such paragraph, that the qualifying investments of the private fund are predominantly qualifying investments that were acquired directly from a qualifying portfolio company.

Amend the title so as to read:

A bill to require the Securities and Exchange Commission to revise the definition of a qualifying investment to include an equity security issued by a qualifying portfolio company, whether acquired directly from the company or in a secondary acquisition, for purposes of the exemption from registration for venture capital fund advisers under the Investment Advisers Act of 1940, and for other purposes.

#### PURPOSE AND SUMMARY

On June 21, 2018, Representative Trey Hollingsworth introduced H.R. 6177, the “Developing and Empowering Our Aspiring Leaders Act”. As modified by an amendment in the nature of a substitute, H.R. 6177 requires the U.S. Securities and Exchange Commission (SEC) to revise the definition of a “qualifying investment” under section 275.203(l)–1(c) of title 17, Code of Federal Regulations, to include equity securities issued by a qualifying portfolio company—whether acquired directly from the company or via a secondary transaction. H.R. 6177 will enable funds to increase their ability to provide necessary capital through secondary acquisitions. In doing so, the bill also balances the need for such investments not to be the primary means by which venture capital funds spread their portfolio by requiring the SEC to revise paragraph (a) of section 275.203(l)–1(c) such that a venture capital fund’s “qualifying investments” must be predominantly those that were acquired directly from a qualifying portfolio company. In other words, the legislation will better enable venture capital funds to provide necessary growth capital to companies without having to register as a registered investment adviser (RIA), while continuing to operate in a manner such that the fund is predominantly comprised of qualifying investments that were acquired directly instead of in a secondary acquisition. The legislation requires the SEC to revise its definition within 180 days of enactment.

#### BACKGROUND AND NEED FOR LEGISLATION

The goal of H.R. 6177 is to allow venture funds to continue to provide necessary growth capital to companies by revising the definition of “qualifying investment” to include equity securities acquired in a secondary transaction.

Title IV of the Dodd-Frank Act—the “Regulation of Advisers to Hedge Funds and Others”—mandated that advisers to private funds, such as private equity and hedge funds, register as RIAs under the Investment Advisers Act of 1940. Title IV also included a provision, Section 407, that amends the Advisers Act to exempt advisers to a venture capital fund from SEC registration. Though advisers to venture capital funds were exempt statutorily from registration, the Dodd-Frank Act required that the SEC define what qualified as a venture capital fund. On July 21, 2011, the SEC’s rules to define venture capital became effective. The SEC defines a venture capital fund as a private fund that meets the following conditions:

(1) Represents itself as pursuing a venture capital strategy to its investors and prospective investors;

(2) Holds no more than 20 percent 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 Investment Company Act of 1940 and has not elected to be treated as a business development company.

Since the adoption of the definition, venture capital funds have increasingly played an important role to improve the U.S. economy. They invest in companies that help to drive economic growth and play an important role in expanding opportunities for American workers. Venture capital funds provide an average of three million new jobs a year and have been responsible for almost all net new job creation in the U.S. over the last 40 years. In 2017, venture firms invested a total of \$84.2 billion—up 16 percent from 2016 and more than 100 percent from ten years ago.

Despite the best intentions, the RIA rules promulgated by the SEC inadvertently discourage some venture capital firms from continuing to invest in companies through secondary investments. As written, the SEC's rules state that venture capital funds only can have 20 percent of their capital commitments in non-qualifying investments. Qualifying investments are defined as: (1) any equity security issued by a qualifying portfolio company that is directly acquired by the private fund; (2) any equity security issued by a qualifying portfolio company in exchange for directly acquired equity issued by the same qualifying portfolio company; and (3) any equity security issued by a company of which a qualifying portfolio company is majority-owned subsidiary, or a predecessor, and that is acquired by the fund in exchange for directly acquired equity.

This definition prohibits secondary acquisitions from being considered qualifying investments, which means that secondary acquisitions fall into the 20 percent non-qualifying bucket. Accordingly, small private companies that need additional capital to grow and that may help them eventually become public companies cannot turn to venture capital funds for secondary acquisitions because such funds are concerned they will exceed the 20 percent limit—and trigger the requirement to register as a RIA.

A multi-industry Midwestern venture capital firm that invests in growing companies highlighted to the Financial Services Committee the concerns with the current regulatory structure:

Because secondary investments are not qualifying, we have to analyze each of our investments not just to determine whether it's a good company with growth potential, but also whether the secondaries we pick up would push us towards registration. Allowing us to do our company diligence without this risk would make [venture capital] investment easier and better targeted.

The Committee also learned from a Pennsylvania healthcare venture capital firm the negative consequences that limiting a venture capital fund's ability to invest in secondary acquisitions has on growing businesses:

Our firm focuses entirely on providing capital to help entrepreneurs grow young healthcare businesses. In this context, there is sometimes the need to provide these hard working founders with partial liquidity as part of a larger growth financing. Although these deals clearly result in growth of both revenue and jobs, they currently fall outside the venture capital exemption. In our current fund, we are facing the very tough decision of passing on a compelling investment in this category (which would take us over the 20% threshold) in order to avoid registering, which would be a significant burden for our 9 person firm.

This legislation, H.R. 6177, would remedy this problem—a problem that, in particular, limits access to capital for smaller companies—by requiring the SEC to revise the definition of a “qualifying investment” to include secondary acquisitions for purposes of RIA exemptions—thereby allowing venture capital funds to provide capital through secondary acquisitions—while still requiring a private fund’s qualifying investments to be predominately comprised of equity securities acquired directly from a qualifying portfolio company.

As a venture capital firm investing in multiple industries in California stated, “We are one of the oldest venture capital firms in Silicon Valley yet have to constantly monitor our non-qualifying basket to make sure we don’t accidentally foot fault into registration. I believe the SEC made a good faith effort to write an accurate definition of venture capital, but the on the ground reality confirms that it needs an update. The Hollingsworth bill would be a very positive change.” H.R. 6177 is a smart legislative initiative to ensure that venture funds can continue to provide capital to small companies that need investment capital the most.

#### HEARINGS

The subcommittee on Capital Markets, Securities, and Investment held a hearing examining matters relating to H.R. 6177 on May 23, 2018.

#### COMMITTEE CONSIDERATION

The Committee on Financial Services met in open session on July 11, 2018, and ordered H.R. 6177 to be reported favorably to the House, as amended, by voice vote.

#### COMMITTEE VOTES

Clause 3(b) of rule XIII of the Rules of the House of Representatives requires the Committee to list the record votes on the motion to report legislation and amendments thereto. On a motion by Chairman Hensarling, the amendment in the nature of substitute was adopted by voice vote. A secondary motion offered by Chairman Hensarling was made to report the bill, as amended, favorably to the House. The motion was agreed to by a voice vote, a quorum being present.

#### COMMITTEE OVERSIGHT FINDINGS

Pursuant to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the findings and recommendations of the Com-

mittee based on oversight activities under clause 2(b)(1) of rule X of the Rules of the House of Representatives, are incorporated in the descriptive portions of this report.

PERFORMANCE GOALS AND OBJECTIVES

Pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee states that H.R. 6177 will reduce the regulatory burden on venture funds while allowing them to continue providing their crucial growth capital to companies.

NEW BUDGET AUTHORITY, ENTITLEMENT AUTHORITY, AND TAX EXPENDITURES

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee adopts as its own the estimate of new budget authority, entitlement authority, or tax expenditures or revenues contained in the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

CONGRESSIONAL BUDGET OFFICE ESTIMATES

Pursuant to clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, the following is the cost estimate provided by the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974:

U.S. CONGRESS,  
CONGRESSIONAL BUDGET OFFICE,  
*Washington, DC, July 17, 2018.*

Hon. JEB HENSARLING,  
*Chairman, Committee on Financial Services,  
House of Representatives, Washington, DC.*

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 3555, H.R. 6177, H.R. 6319, H.R. 6320, H.R. 6321, H.R. 6322, H.R. 6323, and H.R. 6324.

If you wish further details on these estimates, we will be pleased to provide them. The CBO staff contact is Stephen Rabent.

Sincerely,

MARK P. HADLEY  
(For Keith Hall, Director).

Enclosure.

*Securities and Exchange Commission Legislation*

On July 11, the House Committee on Financial Services ordered eight bills to be reported related to the rules, regulations, and operations of the Securities and Exchange Commission (SEC). The bills are:

- H.R. 3555, the Exchange Regulatory Improvement Act, would require the Securities and Exchange Commission (SEC) to issue regulations regarding its definition of what constitutes a facility used by a national securities exchange;
- H.R. 6177, the Developing and Empowering our Aspiring Leaders Act of 2018, would direct the SEC to conduct a rule-making to expand what types of asset acquisitions are considered qualifying investments for a venture capital fund;

- H.R. 6319, the Expanding Investment in Small Business Act, would require the SEC to conduct a study on the limitation on the amount of outstanding securities a closed-end fund may hold from a single issuer and still be classified as diversified;
- H.R. 6320, the Promoting Transparent Standards for Corporate Insiders Act, would require the SEC to conduct a study of various proposals to change agency rules regarding the use of written trading plans by certain securities traders;
- H.R. 6321, the Investment Adviser Regulatory Flexibility Improvement Act, would require the SEC to revise the definitions of a small business and small organization applicable for assessing the effect of the agency's rulemakings under the Investment Advisers Act of 1940 on those entities;
- H.R. 6322, the Enhancing Multi-Class Share Disclosures Act, would direct the SEC to issue a rule requiring securities issuers with multi-class stock structures to make disclosures regarding the voting power of certain individuals;
- H.R. 6323, the National Senior Investor Initiative Act of 2018, would direct the SEC to establish a taskforce to identify challenges that senior investors face and to report on its findings every two years; and
- H.R. 6324, the Middle Market IPO Underwriting Cost Act, would direct the SEC to study the costs associated with small and medium-sized companies undertaking an initial public offering and to report on its findings.

Using information from the SEC regarding the costs of similar activities, CBO estimates that implementing seven of those bills—H.R. 3555, H.R. 6177, H.R. 6319, H.R. 6320, H.R. 6321, H.R. 6322, and H.R. 6324—would each have a gross cost of about \$1 million for the agency to conduct the required studies and rulemakings and to issue reports. CBO estimates that implementing the eighth bill—H.R. 6323—would have a gross cost of \$7 million over the 2019–2023 period for the SEC to establish and carry out the functions of the taskforce established under the bill.

However, the SEC is authorized to collect fees sufficient to offset its annual appropriation; therefore, CBO estimates that the net effect on discretionary spending of implementing each of those bills would be negligible, assuming appropriation actions consistent with that authority. H.R. 6323 also would require the Government Accountability Office (GAO) to conduct a study on the economic costs of the financial exploitation of senior citizens and CBO estimates that implementing that section would cost GAO less than \$500,000; such spending would be subject to the availability of appropriated funds.

None of the bills would affect direct spending or revenues; therefore, pay-as-you-go procedures do not apply for any of the eight bills.

None of the bills would increase net direct spending or on-budget deficits in any of the four consecutive 10-year periods beginning in 2029, CBO estimates.

None of the bills contain intergovernmental mandates as defined in the Unfunded Mandate Reform Act (UMRA) and would not affect the budgets of state, local, or tribal governments. All of them would require the SEC to take actions that could raise the agency's

administrative costs and the fees it collects to offset those costs. If the SEC increased fees, it would increase the cost of an existing mandate on private entities required to pay those fees. CBO estimates that none of the bills would increase fees in an amount that would exceed the annual threshold for private-sector mandates established in UMRA (\$160 million in 2018, adjusted annually for inflation).

The CBO staff contacts for this estimate are Stephen Rabent (for federal costs) and Rachel Austin (for mandates). The estimate was reviewed by H. Samuel Papenfuss, Deputy Assistant Director for Budget Analysis.

#### FEDERAL MANDATES STATEMENT

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995.

The Committee has determined that the bill does not contain Federal mandates on the private sector. The Committee has determined that the bill does not impose a Federal intergovernmental mandate on State, local, or tribal governments.

#### ADVISORY COMMITTEE STATEMENT

No advisory committees within the meaning of section 5(b) of the Federal Advisory Committee Act were created by this legislation.

#### APPLICABILITY TO LEGISLATIVE BRANCH

The Committee finds that the legislation does not relate to the terms and conditions of employment or access to public services or accommodations within the meaning of the section 102(b)(3) of the Congressional Accountability Act.

#### EARMARK IDENTIFICATION

With respect to clause 9 of rule XXI of the Rules of the House of Representatives, the Committee has carefully reviewed the provisions of the bill and states that the provisions of the bill do not contain any congressional earmarks, limited tax benefits, or limited tariff benefits within the meaning of the rule.

#### DUPLICATION OF FEDERAL PROGRAMS

In compliance with clause 3(c)(5) of rule XIII of the Rules of the House of Representatives, the Committee states that no provision of the bill establishes or reauthorizes: (1) a program of the Federal Government known to be duplicative of another Federal program; (2) a program included in any report from the Government Accountability Office to Congress pursuant to section 21 of Public Law 111-139; or (3) a program related to a program identified in the most recent Catalog of Federal Domestic Assistance, published pursuant to the Federal Program Information Act (Pub. L. No. 95-220, as amended by Pub. L. No. 98-169).

#### DISCLOSURE OF DIRECTED RULEMAKING

Pursuant to section 3(i) of H. Res. 5, (115th Congress), the following statement is made concerning directed rule makings: The Committee estimates that the bill requires one directed rulemaking to require the SEC to revise the definition of qualifying investment

to include equity securities offered by a qualifying portfolio company whether acquired directly or in a secondary transaction and to condition that to qualify as a venture capital fund private funds are still predominately comprised of qualifying investments that were acquired directly from a qualifying portfolio company.

#### SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

##### *Section 1. Short title*

This Section cites H.R. 6177 as the “Developing and Empowering our Aspiring Leaders Act of 2018.”

##### *Section 2. Definitions*

This section requires the SEC, within 180 days of enactment, to revise the definition of qualifying investments under paragraph (c) of section 275.203(l)-1 of title 17, Code of Federal Regulations to include equity securities offered by a qualifying portfolio company acquired in a secondary acquisition. Additionally, the bill would revise paragraph (a) to ensure that private funds are still predominately comprised of qualifying investments that we acquired directly from a qualifying portfolio company.

#### CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows: H.R. 6177 does not repeal or amend any section of a statute. Therefore, the Office of Legislative Counsel did not prepare the report contemplated by clause 3(e)(1)(B) of rule XIII of the Rules of the House of Representatives.