

# Recommendations for Enhancing Venture Capital in Azerbaijan

## Definitions:

It's crucial to have clear definitions in the legal framework of Azerbaijan for Venture Capital Markets:

1. Clear definition of what is an investment adviser to the Venture Fund and why there should be an exemption for such kinds of investment advisors
2. Clear definition of what a startup is (qualifying portfolio company)
3. What should be the minimum number of accredited investors or other
4. Accredited investor
5. Capital gain and loss
6. Innovation
7. Special Purpose Vehicle (SPV)
8. General solicitation
9. Stocks

## Definition of Venture Capital Fund (VCF) - US Definition:

- A private fund that: invests in equity securities of private companies in order to provide operating and business expansion capital ("qualifying portfolio companies), and at least 80 percent of each company's securities owned by the fund were acquired directly from the qualifying portfolio company (Startup);
- directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company;
- does not borrow or otherwise incur leverage (other than limited short term borrowing);
- does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; represents itself as a venture capital fund to investors;
- venture capital fund for the purposes of the exemption as a fund invests in equity securities issued by "qualifying portfolio companies"

## **Definition of Qualifying Portfolio Companies (Startup):**

Generally, any company that: is not publicly traded; does not incur leverage in connection with the investment by the private fund; uses the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors; and is not itself a fund (i.e., is an operating company).

But the Government of Azerbaijan could clarify in more details the definition of the Startup and connect it with the Innovation Component.

For example:

Startup - early-stage company created for the purpose of developing an Innovative product, service or process, which has a practical implementation, and makes a meaningful impact in a market or society, has the ability to advance, compete and differentiate itself from others.

## **Definition of Innovation:**

Innovation can be described as the introduction of an entirely novel or significantly enhanced product, service, or process that not only has a practical application but also the potential to create a substantial impact in the market or society. According to the standard ISO 56000:2020 [2], innovation is defined as "a new or transformed entity that realizes or redistributes value."

The definition of innovation is paramount, especially in the context of governmental support. Governments often encourage startups that lean towards technological or IT-centric innovations. However, this perspective is evolving. By promoting truly innovative startups, the focus is shifted to ensuring that early-stage businesses are oriented towards making significant enhancements to existing products or services or introducing entirely new ones. These innovations should not only have a practical application but also deliver substantial benefits to the market or society. This could be in the form of improved quality, faster product or service delivery, user-friendliness, cost-effectiveness, or other economic or social advantages."

## **Definition of Investment Advisor:**

- Investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or

selling securities, or who for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."

- Giving of advice need not constitute the principal business activity or any particular portion of the business activities in order for a person to be an investment adviser.
- Giving of advice need only be done on such a basis that it constitutes a business activity occurring with some regularity. The frequency of the activity is a factor, but is not determinative.

In general Investment Advisor is a person or company which is providing to the Venture Capital Fund advice where to invest money (Management Firm or GP)

### **Definition of Accredited Investor:**

An accredited investor is a designation for investors who meet certain minimum income or net worth requirements. Accredited investors should be financially sophisticated and able to fend for themselves or sustain the risk of loss.

### **Definition of Net worth**

Total value of an individual's or entity's assets minus their liabilities

### **Definition of Capital Gain**

Capital gains are the profits that are realized by selling an investment, such as stocks, bonds, or real estate.

### **Definition of Capital Loss**

A capital loss in venture capital arises when an investment is sold for less than its purchase price, representing the negative difference between the sale price and its original cost.

### **Definition of Special Purpose Vehicle**

Special Purpose Vehicle (SPV) is a distinct legal entity formed to pool multiple investors' funds for a singular investment in a startup, streamlining the company's cap table.

## **Definition of SEC and ECB for SPV**

- U.S. Securities and Exchange Commission (SEC):  
"A special purpose vehicle, also called a special purpose entity (SPE), is a subsidiary created by a parent company to isolate its financial risks."
- The European Central Bank (ECB):  
"A Special Purpose Entity (SPE) is a legal entity (or entities), typically a subsidiary of a larger entity, created to fulfill narrow, specific, or temporary objectives, particularly to isolate the parent firm from financial risk."

## **Definition of General Solicitation**

- **U.S. (Securities and Exchange Commission (SEC)):**  
General Solicitation is any act of publicly advertising the offering and sale of securities, whether through public media such as newspapers, internet advertisements, websites, television and radio broadcasts, public seminars or meetings."
- **Europe (European Securities and Markets Authority (ESMA)):**  
General Solicitation refers to the direct or indirect offering or placement, at the initiative of the Alternative Investment Fund Manager (AIFM) or on behalf of the AIFM, of units or shares of an Alternative Investment Fund (AIF) to or with investors domiciled or with a registered office in the Union."

## **Definition of Stocks ( In the case of C-corporations, analog in Azerbaijan is Joint Stock Company)**

- U.S. Definition:  
"Stock in a C-corporation represents ownership in the company and embodies the rights of the shareholder as provided by the corporation's bylaws and state law. It may come in various classes, each with its own set of rights, and can confer voting rights, dividend rights, and other privileges."
- European Definition:  
"Shares in a company represent units of ownership interest or the right to a portion of the profits if dividends are declared. In European company structures, shares can take various forms and classes, conferring different rights to the holders as per the company's articles of association and local jurisdictional laws."

## **How to Grow an Attractiveness of Azerbaijan as a Domicile for Investment Advisor for VCF (Venture Capital Fund) and Venture Fund registration and development.**

The government should take steps in several directions to transform Azerbaijan into an attractive Domicile for Investment Advisors for Venture Capital Funds and Venture Fund registration and development.

Government should Improve:

1. Process of the Registration of Investment Advisors for Venture Capital Funds
2. Process of the business entities registration in Azerbaijan from abroad (LLC, LP, C-Corp)
3. Process of registration of the Joint Stock Companies for startups (Analog of C-corporation)
4. Taxation for Capital Gains and Loss

The most advanced registration domicile currently is the US. Reform initiated by Barack Obama fostered the development of Venture Capital in the US. The Dodd-Frank act (DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT) created a new exemption especially for investment advisers to "venture capital funds".

### **Principles of forming Venture Capital Fund:**

Venture capital fund has a distributed structure where an Investment Advisor is a separate person or company.

Usually Venture Capital Fund and investment advisers to "venture capital funds" using different legal structures.

- The fund is concerned with pooling capital, setting investment objectives, risk parameters, etc.
- An investment advisor is concerned with executing the investment strategy to meet those objectives, making investment decisions, and potentially managing the day-to-day investment operations.
- It's better to have two separate business entities for the operation and management of the process of pooling capital and investment advisory services.
- Most of the Managing firms (Investment Advisors) are using legal form of Limited Liability Company (LLC)
- Venture Capital Funds are using legal form of Limited Partnership (LP)

- The Venture Capital funds by themselves do not generally register with the entity responsible for the registration and regulation of investment advisers but are subject to certain regulations, reporting requirements, and exemptions.
- Investment advisors to venture capital funds usually need to register with the entity responsible for the registration and regulation of investment advisers unless they qualify for an exemption.

## Why LP (Limited Partnership) is a better form for the Venture Fund Structure (In Azerbaijan analog is Commandite Society )

An LP consists of one or more general partners (GPs) and limited partners (LPs).

- The GP is responsible for managing the LP, making investment decisions, and handling day-to-day operations. GPs have unlimited liability, meaning they can be held personally liable for the debts and obligations of the LP.
- That's why an LLC is often used to serve as the GP, as it provides a layer of liability protection. LLC itself becomes the GP, providing a shield against the unlimited liability that would otherwise apply to individual general partners. By structuring the GP as an LLC, the individuals behind the LLC can protect their personal assets from the liabilities of the partnership.
- LPs are typically passive investors who contribute capital but do not participate in the management of the LP. LPs enjoy limited liability, meaning they can lose no more than the amount they invested in the LP.
- An LP has a clear division between the general partner (GP), who manages the fund, and the limited partners (LPs), who are primarily passive investors.
- As in a general partnership, the GPs have actual authority, as **agents** of the firm, to bind the partnership in **contracts** with third parties that are in the ordinary course of the partnership's business. As with a general partnership, "an act of a general partner which is not apparently for carrying on in the ordinary course the limited partnership's activities or activities of the kind carried on by the limited partnership binds the limited partnership only if the act was actually authorized by all the other partners
- Like **shareholders** in a **corporation**, limited partners have **limited liability**. This means that the limited partners have no management authority, and (unless they obligate themselves by a separate contract such as a guarantee) are not liable for the debts of the partnership. The limited partnership provides the limited partners a return on their investment (similar to a **dividend**), the nature and extent of which is usually defined in the partnership agreement. General Partners thus

bear more economic risk than do limited partners, and in cases of financial loss, the GPs will be the ones which are personally liable.

## **Why GPs in Limited Partnership is better to be formed as an LLC** (Analog in Azerbaijan is Məhdud Məsuliyyətli Cəmiyyə)

An LLC is a more flexible structure and combines several elements. It has members instead of partners.

- Members of an LLC can participate in the management of the LLC without incurring personal liability for the LLC's debts and obligations. This is different from an LP, where GPs, who manage the LP, have unlimited liability.
- Like an LP, an LLC is a pass-through entity for tax purposes, meaning that income, losses, deductions, and credits pass through the LLC to its members, who report these items on their personal tax returns.
- The LLC structure can be beneficial for venture funds that prefer a more flexible management structure and limited liability for all investors. However, it's less commonly used for venture funds than the LP structure.
- As its name implies, an LLC provides its members with limited liability. This means the personal assets of the members are generally protected from the LLC's debts and liabilities.

## **Why is it better to use LLC as an GP**

Why is it better to use Limited Partnership as a core for the process of working with LPs and to have as a GP an LLC

- The GP is responsible for managing the LP, making investment decisions, and handling day-to-day operations. GPs have unlimited liability, meaning they can be held personally liable for the debts and obligations of the LP.
- That's why an LLC is often used to serve as the GP, as it provides a layer of liability protection. LLC itself becomes the GP, providing a shield against the unlimited liability that would otherwise apply to individual general partners. By structuring the GP as an LLC, the individuals behind the LLC can protect their personal assets from the liabilities of the partnership.

## What should be improved for the quick and flexible registration of LLC and LP in Azerbaijan

### Name Checking for LLC and LP

For starting the registration of a person locally or from abroad could check the name for LLC or LP.

For example in the US you could check the name for LLC and LP and fund during the registration in Delaware, online.

Check the name of the fund

<https://icis.corp.delaware.gov/ecorp/entitysearch/namesearch.aspx>

- You need name for the Managing Firm which will have a legal status as LLC
- You should choose a name for the Venture Capital Fund which is better to serve as a Limited Partnership.

Currently in US you could check the name of both legal entities if you are going to register them in Delaware by the Delaware Division of Corporations' website

<https://icis.corp.delaware.gov/ecorp/entitysearch/namesearch.aspx>

### First step is:

**Initial Verification:** This is when you use the online search tool provided by the Delaware Division of Corporations to check whether your desired fund name is already in use by another business entity registered in Delaware. If your exact name or a very similar one appears in the search results, it's already taken and you'll need to choose a different name. - <https://icis.corp.delaware.gov/ecorp/entitysearch/namesearch.aspx>

### You've also need official verification:

**Official Verification:** After you've checked the name's availability using the search tool and prepared your Certificate of Limited Partnership (or Certificate of Formation, if you're forming an LLC), you will submit these documents to the Delaware Division of Corporations. The Division of Corporations will then conduct an official verification of the name's availability as part of its review process.



## **Second step is registration of company address, postal address, and phone number**

For registration of LLC, LP, Investment Advisor you need postal address, physical address and phone number.

To address LP or LLC you need an official address of your fund in Delaware, It must be a physical street address, not a PO Box. This is where official mail from the state, including legal notices, will be sent. If your fund does not have a physical presence in Delaware, you can use a registered agent service that provides a registered office address. If you don't have an address, you have to use the Registered Agent Service.

## **Regulation of Registered Agent Services**

Registered Agent services are governed by state law. In Delaware, the relevant legislation is the Delaware General Corporation Law (Title 8, Delaware Code), the Delaware Limited Liability Company Act, and the Delaware Revised Uniform Limited Partnership Act.

**Registered Agent Service** - is an outsourcing organization which provides an official point of contact for a business, receiving legal and official documents on its behalf in the jurisdiction where the business is registered.

## **Examples of Registered Agent Services in US**

**CT Corporation:** Serve entities of all sizes, from startups to Fortune 500 companies.

**LegalZoom:** LegalZoom provides a variety of other legal services for businesses, such as forming your business entity.

**Incfile:** Provides free Registered Agent services for one year when you form your business entity with them.

## **Business Entities should also get Taxpayers number**

In US it's Employer Identification Number (EIN) - Internal Revenue Service (IRS)

An Employer Identification Number (EIN) is a unique identification number that is assigned by the Internal Revenue Service (IRS) to a business entity in the United States. It is used by the IRS to identify taxpayers that are required to file various

business tax returns.

Both LLC and LP needs EIN or Taxpayers number

## **Registration of LLC as an Investment Advisor for Venture Capital Fund**

In most of the countries governments created special exemptions for the Investment Advisors to the Venture Capital Funds.

In the US it's a Dodd Frank Act, the same situation is in Singapore, Canada and other countries.

Usually an Investment Advisor to the Venture Capital Fund should register as a typical investment advisor if the amount of the fund is high.

In the U.S., managers of Venture Capital Funds may use the "Venture Capital Fund Advisor" exemption to avoid registration but might still have "exempt reporting adviser" obligations.

In any case you should pass through several actions to start an Investment Advisory Service for Venture Capital Funds.

In some cases you should pass through simple registration in organizations like the Financial Industry Regulatory Authority (FINRA). The Financial Industry Regulatory Authority (FINRA) is not a government agency, its creation and rules are subject to government oversight, primarily by the U.S. Securities and Exchange Commission (SEC). The SEC approved the creation of FINRA through regulatory approval processes. The SEC reviews and approves FINRA's rules and regulations to ensure that they align with investor protection and market integrity goals. During registration you are getting IARD Number (Investment Adviser Registration Depository (IARD)).

You also should fill the Form ADV.

### **What is Form ADV (Prospectus)**

Form ADV is the uniform form used by investment advisers to register with the entity responsible for the registration and regulation of investment advisers. It provides detailed information about the adviser that can be used by both regulators and the general public to evaluate the adviser's business operations,

potential conflicts of interest, and the overall risk associated with the adviser.

## Content of Form ADV

Form ADV is divided into two main parts, each serving a distinct purpose:

- **Part 1:**
  - **Information about the Investment Adviser:** This section collects basic identifying information about the adviser, including the business's name, address, contact details, and form of organization.
  - **Other Business Activities:** Advisers must disclose other business activities they are engaged in, which might pose conflicts of interest.
  - **Fees and Compensation:** Details about how the adviser is compensated for their services.
  - **Affiliations:** Any affiliations with other financial industry participants that could pose conflicts of interest.
  - **Disciplinary Information:** Past disciplinary events involving the adviser or its key personnel.
  - **Client Types and Advisory Activities:** Types of clients the adviser typically serves, types of advisory services offered, and methods of analysis used.
  - **Custody:** Whether the adviser has custody (control or access) over client funds or securities.
  - **Participation in Client Transactions:** Whether the adviser participates in or has an interest in client transactions.
  - **Personal Trading:** Personal securities trading by the adviser and its personnel.
- **Part 2:**
  - **Brochure (Part 2A):** This narrative document provides detailed information about the adviser's services, fees, investment strategies, risks, disciplinary information, conflicts of interest, and more. It's written in plain English and is intended to be given to clients and potential clients.
  - **Brochure Supplements (Part 2B):** This provides information about specific individuals who provide investment advice and interact with clients. It contains details about their educational background, business experience, disciplinary history, and other relevant data.

## Singapore Example

- Managers of venture capital funds may also apply to operate under the venture capital fund manager (VCFM) regime.

- Acquiring your own license in Singapore can be a costly process, as it requires having a physical office in Singapore with at least two full-time professionals who are based in Singapore. In addition, there is a need to hire compliance, accounting, and auditing service providers. The expenses associated with setting up a licensed fund management company and subsequently a VCC fund in Singapore could've substantial annual and setup fees depending on factors such as office rental, salaries of experienced professionals and cost of service providers.

### **Canada Example**

- VC activity is centered in urban areas that also have strong tech sectors, however this report will focus on Ontario as Ontario has the majority of registered venture funds compared to the other provinces. Funds formed in Ontario are mostly structured as limited partnerships.
- Fund offerings made to the public in Ontario require that the fund's prospectus be registered with the Ontario Securities Commission (OSC) ; however, venture capital funds may be able to rely on exemptions that preclude them from government registration.

### **Why the most costly procedure in starting Investment Advisory Service to Venture Capital Fund is a Lawyers service.**

1. Preparing the Form ADV (the primary registration document for investment advisers with the SEC) requires a deep dive into the adviser's operations, strategies, fee structures, potential conflicts of interest, and more. Each part of this form requires careful attention to detail and often necessitates the expertise of legal professionals.
2. The registration process is just the beginning. Investment advisers have ongoing reporting, recordkeeping, and other compliance obligations. There's also a need to stay updated with changing regulations and regulatory interpretations, which can necessitate ongoing legal consultation.
3. Each U.S. state may have its own requirements for investment advisers. Understanding and complying with these requirements in each state where an adviser operates can add to the complexity and cost.

### **3. Why there should be analog of C-corp in legislation of Azerbaijan to register startups**

As usual venture capital funds with the help of Investment Advisors, investing in startups which should have a correct legal structure. The structure of the startups should make it possible to issue different types of shares in Joint Stock Companies (Analog of C-Corps). This element is also important in the case that a Venture Fund should manage its assets and have an appropriate environment for this.

#### **Issuing stocks by C-corp**

The issuance of stocks by C corporations in the United States is governed by federal securities laws, specifically the Securities Act of 1933. This law requires corporations to register their securities (including stocks) with the U.S. Securities and Exchange Commission (SEC) before they can be sold to the public.

However, there are certain exemptions from this registration requirement. Most startups and small businesses use one of these exemptions because registering a public offering is a complex and expensive process.

For example, one commonly used exemption:

- Rule 506(b) of Regulation D, which allows a corporation to raise an unlimited amount of money from an unlimited number of "accredited investors" (generally, wealthy individuals or institutional investors) and up to 35 non-accredited investors, as long as there is no general solicitation or advertising of the securities offering.
- Rule 506(c) of Regulation D, allows for general solicitation or advertising, but all purchasers of the securities must be accredited investors. In both cases, the issuing corporation must take reasonable steps to verify the investors' accredited status.

#### **What type of Stock might be issued:**

When startups or venture capital-backed companies talk about issuing different classes of shares, they are referring to creating distinct categories of stock, each with its own specific rights, privileges, and restrictions. The reasons for doing this can vary but often center on control, economic rights, or access to information. Here's a closer look at the context and implications:

## Why Issue Different Classes of Shares?

**Control Over Decisions:** Founders may want to maintain control over strategic decisions, even as they raise capital and dilute their economic ownership. By issuing shares with different voting rights (e.g., 10 votes per share for one class vs. 1 vote per share for another), they can retain control even if they own less than 50% of the company's economic value.

**Different Economic Rights:** Different classes might have different rights to dividends or distributions, or different rights in a liquidation scenario. For instance, preferred stock (common in venture capital deals) might have a preference, meaning they get paid out first in a liquidation event.

**Access to Information or Protective Provisions:** Some classes of shares might have rights to more information, or rights to approve or veto certain critical decisions.

## Classes of Shares (Stocks)

**Common Stock:** Common stockholders have the right to vote on corporate matters such as the election of the board of directors and significant corporate transactions. They are the last to receive any remaining assets of the corporation in the event of liquidation, after all debts and obligations have been paid, and after preferred stockholders. However, they have the potential to share in the company's success through rising stock prices and dividends, though dividends are not guaranteed.

**Preferred Stock:** Preferred stockholders typically do not have voting rights. However, they have a higher claim on the corporation's earnings and assets than common stockholders. This means they get paid dividends before common stockholders and, in the event of liquidation, they are paid before common stockholders. The dividends for preferred stocks can be fixed or set in relation to a benchmark interest rate. Preferred stock can sometimes be converted into common stock.

**Employee Stock Option Plans (ESOPs):** These are call options on the common stock of a company, issued as a form of non-cash compensation. Restrictions on the option (such as vesting and limited transferability) attempt to align the holder's interest with those of the business shareholders.

**Convertible Notes:** Debt instruments that can convert into equity. Startups often use these in seed rounds because they delay setting a valuation for the company.

**Restricted Stock Units (RSUs):** These grant the right to receive shares after certain conditions are met, like after a certain period of time (vesting) or when performance milestones are achieved.

**SAFE (Simple Agreement for Future Equity):** An instrument used in early-stage investing as an alternative to convertible notes. It's an agreement to provide a future equity stake based on an amount invested now, without determining a specific price per share.

In the United States, the granting of stock options to employees is primarily governed by the federal tax laws, specifically Section 422 of the Internal Revenue Code (IRC) which pertains to Incentive Stock Options (ISOs), and Section 409A which pertains to non-qualified stock options (NSOs) and other types of deferred compensation.

Incentive Stock Options (ISOs) have special tax advantages. They are not taxed when granted or when exercised (assuming certain conditions are met). Instead, they are taxed at the capital gains rate when the shares are sold, provided certain holding period requirements are met. This rate is typically lower than the ordinary income tax rate.

Non-Qualified Stock Options (NSOs), on the other hand, do not have these special tax advantages. They are not taxed when granted, but they are taxed as ordinary income when exercised, meaning the employee must pay income tax on the difference between the exercise price and the fair market value of the stock at the time of exercise.

In addition to these tax laws, stock option plans also need to comply with the federal securities laws. For example, the issuance of stock options typically falls under Rule 701 of the Securities Act of 1933, which provides an exemption from registration for securities issued as part of a written compensation agreement to employees, directors, general partners, trustees, officers, or certain consultants or advisors.

## **10. Introduction of Non-Equity Instruments**

**A Simple Agreement for Future Equity (SAFE)** is a contract between an investor and a company that provides rights to the investor for future equity in the company. **Safe is** a contractual agreement for future equity, so there's typically no exchange of property or realization of income at the time the SAFE is signed. Taxes would likely become relevant later when the SAFE is converted into actual equity (Stocks), or if there are other related transactions or income

**Valuation Cap:** This is the maximum valuation of a company at which SAFE can be converted into equity. It is used to protect the investor by ensuring that they receive a

minimum percentage of the company on a SAFE conversion, no matter how high the company's valuation. For example, if SAFE has a valuation cap of \$5 million, and in the next funding round, the startup values the company at \$10 million, the SAFE investor's shares are valued as if the company were only worth \$5 million, resulting in more shares.

**Discount Rate:** This is the percentage by which the investor receives a "discount" from the share price at the time of the event. This discount is a reward for early investment. For example, at a discount rate of 20%, if new investors in the funding round pay \$1 per share, then the SAFE investor will only pay \$0.80 per share.

## 11. Clear Taxation Guidelines for Investment Proceeds and Distributions:

### Capital gain:

Capital gain is the profit realized from the sale of a startup's equity or investment that the venture capital firm holds. Specifically, it's the difference between the sale price of the investment and its purchase price. The taxation rate on this gain depends on how long the investment was held:

**Short-Term Capital Gain:** If the venture capital firm held the investment for one year or less before selling, the gain is considered short-term and is taxed at ordinary income tax rates.

**Long-Term Capital Gain:** If the investment was held for more than one year before being sold, the gain is considered long-term and is generally taxed at a lower rate than ordinary income.

For venture capitalists and startups, Singapore's tax system is advantageous. When a venture capital firm invests in a startup and later sells its stake at a profit, this profit is typically considered a capital gain and not taxed.

The opposite of a capital gain is a capital loss, which occurs when the sale price of an asset is less than the purchase price. Depending on the tax laws in the country, it is possible to use capital losses to offset capital gains, thereby reducing your taxable income.

**Canada:** The Canada Revenue Agency allows capital losses to be deducted against capital gains. If your losses exceed your gains, you can carry back the loss to any of the three preceding years or carry forward the loss indefinitely to offset gains in the future.



## **Capital loss:**

Capital loss occurs when a venture capital firm sells an investment in a startup or other early-stage company for less than its purchase price. Essentially, it's the negative difference between the sale price of the investment and its cost basis

**Offsetting Gains:** Capital losses can be used to offset capital gains in the same tax year. If the capital losses exceed the capital gains, the excess can often be used to offset up to a certain amount of ordinary income.

**Carry Forward:** If a venture capitalist has more capital losses than gains in a given tax year, they may be able to carry forward the remaining capital loss to offset future gains or income.

**Holding Period:** Just as with capital gains, capital losses are classified as either short-term or long-term based on how long the investment was held. This classification impacts how the loss can be used to offset gains.

## **12. Special Purpose Vehicles (SPVs)**

Special Purpose Vehicle (SPV) is a distinct legal entity formed to pool multiple investors' funds for a singular investment in a startup, streamlining the company's cap table.

### **SPV is not issuing stocks that's why it might be formed as:**

- **Limited Liability Company (LLC):** This is the most commonly used structure for SPVs in the U.S., especially in real estate and venture capital settings. An LLC offers flexibility in terms of its operating agreement, allowing parties to define their rights and obligations. It provides limited liability to its members and allows for pass-through taxation, meaning the company itself isn't taxed, but the income or losses are passed through to its members.
- **Corporation (often a C Corporation):** Some SPVs are set up as corporations, especially if they're used for securitization purposes. Unlike LLCs, corporations have double taxation (both the corporation and the shareholders are taxed), but they offer a distinct structure with shares that can be transferred or sold.
- **Limited Partnership (LP):** Less common than LLCs but still used, an LP has general partners (who have unlimited liability) and limited partners (who have limited liability). This structure is sometimes preferred when there are active managers (general partners) and passive investors (limited partners).

### 13. Minimum Capital Requirements for Investors

There's no standardized minimum investment for LPs set by regulation. VCFs themselves decide their minimums, and it's often based on the fund's size and strategy. Often, VCFs in the U.S. only accept "accredited investors" as defined by the SEC. This definition sets criteria related to an investor's net worth and income but doesn't specify a minimum investment amount in the fund.

### 14. Definition of Net Worth for Investor Eligibility

"Accredited Investor" Net Worth Standard -

<https://www.sec.gov/info/smallbus/secg/accredited-investor-net-worth-standard-secg>

(US Example)

What are the requirements for an individual to qualify as an "accredited investor" based on net worth?

- The individual must have *a net worth greater than \$1 million*, either individually or jointly with the individual's spouse. Except for the special provisions described below, individuals should include all of their assets and all of their liabilities in calculating net worth.
- The *primary residence is not counted as an asset in the net worth calculation*. The term "primary residence" is not defined in SEC rules but is commonly understood to mean the home where a person lives the most of the time.
- *In general, debt secured by the primary residence (such as a mortgage or home equity line of credit) is not counted as a liability in the net worth calculation if the estimated fair market value of the residence is greater than the amount of debt secured by it*. There is no requirement to obtain a third party estimate of the fair market value of the residence.
- *However, if the amount of debt secured by the residence has increased in the 60 days preceding the sale of securities to the investor (other than in connection with the acquisition of the primary residence), then the amount of that increase is included as a liability in the net worth calculation*, even if the estimated value of the residence is greater than the amount of debt secured by it. The purpose of this provision is to deter individuals from incurring debt secured by their primary residence for the purpose of inflating their net worth to qualify as accredited investors in purchasing securities.
- *If the amount of debt secured by the primary residence is greater than the estimated fair market value of the residence, then the excess is included as a liability in the net worth calculation*. Where the amount of secured debt is greater

than the value of the primary residence, such as when a mortgage is “underwater,” the excess is counted as a liability when calculating net worth. This is true even if the borrower may not be personally liable for the excess amount by reason of the contractual terms of the debt or the operation of state anti-deficiency statutes or similar laws.

The primary residence can be included in the net worth calculation for certain follow-on investments

The former accredited investor net worth test, under which the primary residence and indebtedness secured by it are included in the net worth calculation, applies to *purchases of securities in accordance with a right to purchase such securities*, if:

- The *right was held by a person on July 20, 2010*, the day before the enactment of the Dodd-Frank Act;
- The person *qualified as an accredited investor on the basis of net worth at the time the right was acquired*; and
- The person *held securities of the same issuer, other than the right, on July 20, 2010*.

Examples of accredited investor net worth calculations:

Assume an investor holds the following assets and liabilities as of the date of purchase in a securities offering:

Assets		Liabilities	
Primary residence:	\$1,200,000	Mortgage/HELOC:	\$800,000
Other assets:	850,000	Other debt:	20,000

(a) *Basic net worth calculation with positive home equity:*

Assets		Liabilities	
Primary residence:	\$<excluded>	Mortgage/HELOC:	\$<excluded>
Other assets:	<u>850,000</u>	Other debt:	<u>20,000</u>
Total assets:	\$ 850,000	Total liabilities:	\$ 20,000
Individual’s net worth: \$850,000 - \$20,000 = \$830,000			

(b) *Net worth calculation with a recent debt increase:* If the amount of the mortgage/home equity line of credit indebtedness has increased within 60 days of the purchase of securities (for example, because of a \$10,000 drawdown under the HELOC), then the amount of that increase would be included as a liability in the person’s net worth calculation:

Assets		Liabilities	
Primary residence:	\$<exclude >d>	60-day increase:	\$ 10,0 00
Other assets:	<u>850,000</u>	Other debt:	<u>20,000</u>
Total assets:	\$ 850,000	Total liabilities:	\$ 30,0 00
Individual's net worth: \$850,000 - \$30,000 = \$820,000			

(c) *Net worth calculation with negative home equity*: If the fair market value of the person's primary residence fell to \$600,000, but the value of the mortgage remained at \$800,000, the net worth calculation would be:

Assets		Liabilities	
Primary residence:	\$<exclude >d>	Mortgage >\$600, 000:	\$ 200,0 00
Other assets:	<u>850,000</u>	Other debt:	<u>20,000</u>
Total assets:	\$ 850,000	Total liabilities:	\$ 220,0 00
Individual's net worth: \$850,000 - \$220,000 = \$630,000			

Other resources:

### Accredited investor

In the United States, the Securities and Exchange Commission (SEC) sets the criteria for who qualifies as an "accredited investor." The goal of this designation is to protect potential investors by ensuring they either have a sufficient income or net worth to handle the risks associated with certain types of investments, like those in venture capital funds or startups.

Here are the requirements for an individual to qualify as an accredited investor (as of my last update in 2021):

Income-based criteria:

- An individual with an income of more than \$200,000 per year for the last two years (or \$300,000 combined income if married) and the expectation of earning the same or higher income in the current year.

Net worth-based criteria:

- An individual or a married couple with a net worth exceeding \$1 million, either individually or jointly. This calculation must exclude the value of their primary residence.

## 15. General Solicitation and Disclaimers

What is General Solicitation?

General solicitation refers to any public promotional or advertising activities aiming to attract investors for securities offerings. It can encompass various activities and mediums, including:

- Seminars or meetings sponsored by the issuer where the offerings are presented to attendees.
- Advertisements published in newspapers or magazines.
- Public websites or publicly accessible online platforms.
- Unsolicited email broadcasts.
- Public webinars or podcasts.
- Television or radio broadcasts.

Why is General Solicitation Relevant?

In many jurisdictions, private offerings (as opposed to public offerings) are exempt from full registration requirements, provided they meet certain criteria. One of the criteria often specified is the absence of general solicitation – essentially, the offering must be made privately and not advertised to the public.

However, acknowledging the evolving nature of fundraising and the digital age, some jurisdictions have introduced or are considering exceptions that allow for general solicitation under strict conditions.

U.S. Context – Regulation D:

In the U.S., the most commonly cited rules related to general solicitation are found in Regulation D of the Securities Act of 1933.

- Rule 506(b): This is the traditional private placement exemption. It does not allow for general solicitation. Instead, sales must be made to investors with whom the issuer (or the person acting on the issuer's behalf) has a pre-existing, substantive relationship.
- Rule 506(c): Adopted after the JOBS Act, this rule allows issuers to engage in general solicitation, but with caveats. The most significant is that sales can only

be made to accredited investors, and the issuer must take reasonable steps to verify that all purchasers are indeed accredited.

Under Rule 506(c), a company can broadly solicit and generally advertise the offering and still be deemed to be in compliance with the **exemption's requirements if:**

- The investors in the offering are all accredited investors; and
- The company takes reasonable steps to verify that the investors are accredited investors, which could include reviewing documentation, such as W-2s, tax returns, bank and brokerage statements, credit reports and the like.

## **16. Regulations on Information Dissemination During Pitches**

When startups pitch to potential investors, there are regulations governing what they can and cannot say, especially if they are seeking investments from the general public. Here's an overview of some of the key considerations regarding information dissemination during pitches, particularly in the U.S.:

**Anti-Fraud Provisions:** Regardless of the specific exemption or rule under which a company is raising capital, anti-fraud provisions always apply. This means that startups can't provide misleading information, make untrue statements, or omit material facts that could mislead potential investors.

Rule 506(b) vs. Rule 506(c) under Regulation D:

**Rule 506(b):** This traditional private placement exemption prohibits general solicitation. Therefore, when pitching under this rule, startups should only approach investors with whom they have a pre-existing, substantive relationship. Any information provided should be accurate and not misleading.

**Rule 506(c):** This rule, which came after the JOBS Act, allows for general solicitation (like public pitching events). However, sales can only be made to accredited investors, and startups must take reasonable steps to verify the accreditation status of these investors. When using this exemption, startups should be particularly cautious about the information they disseminate to ensure compliance.

**General Solicitation:** If a startup is not operating under Rule 506(c) or another exemption that allows for general solicitation, it needs to be very careful about where and how it pitches. Public forums, widely advertised events, or mass emails can be considered general solicitation, which is prohibited under many exemptions.

## **17. Stringent Regulations for CVF Management**

**No regulation**

## **18. Co-Investment by the Government**

Governments may have specific regulatory and compliance requirements that the venture fund will need to adhere to. This might include additional audits, reporting standards, or ethical considerations.

## **19. Protecting the Interests of LPs and GPs**

It's protected by LPA (Limited Partnership Agreement) - legal agreement and structure of Limited Partnerships.

The LPA typically covers a wide range of topics, such as:

- **Commitments and Capital Calls:** This outlines how and when the GP can call on LPs to provide their committed capital. It specifies the notice period, the method of communication, and other logistical details.
- **Management Fees and Carried Interest:** Details how the GP is compensated.
- **Investment Strategy:** Defines the types of investments the fund will target.
- **Reporting Requirements:** Specifies how often the GP should report to LPs, and what information those reports should contain.
- **Term of the Fund:** How long the fund will exist before it needs to liquidate its investments and return capital to LPs.
- **Exit and Liquidation:** How investments are to be liquidated and proceeds distributed.
- **Key Person Clauses:** Conditions that might change fund operations if key members of the GP team depart.
- **Conflict of Interest Provisions:** Governs situations where the interests of the GP might conflict with the interests of the LPs.
- **Default Provisions:** What happens if an LP fails to meet a capital call or otherwise defaults on its obligations.
- **Dispute Resolution:** Outlines how disputes between LPs and the GP will be handled.

## **Only if GP is Accredited Investor**

As for regulation:

While the LPA is primarily a contractual agreement and is thus governed by contract law, provisions related to disclosure and fiduciary duty may be influenced by the Investment Advisers Act of 1940 if the GP is a registered investment adviser. State laws, where the partnership is formed, also play a crucial role. Delaware, for instance, is a popular jurisdiction due to its flexible Limited Partnership Act.

EU: The AIFMD has provisions related to transparency and disclosure that might influence what's included in the LPA, especially concerning rights of investors and conflict of interest policies.

Canada: Provincial securities regulators might have provisions or guidelines that touch on issues commonly addressed in LPAs.

Singapore: The MAS has guidelines that could affect LPAs, particularly concerning valuations, disclosure, and conflicts of interest.

Hong Kong: The SFC's regulations can have an impact, especially in areas related to disclosure and transparency.

## **20. Framework for Committing Capital Based on Capital Calls**

It's mostly regulated by Limited Partnership Agreement (LPA).

It typically outlines:

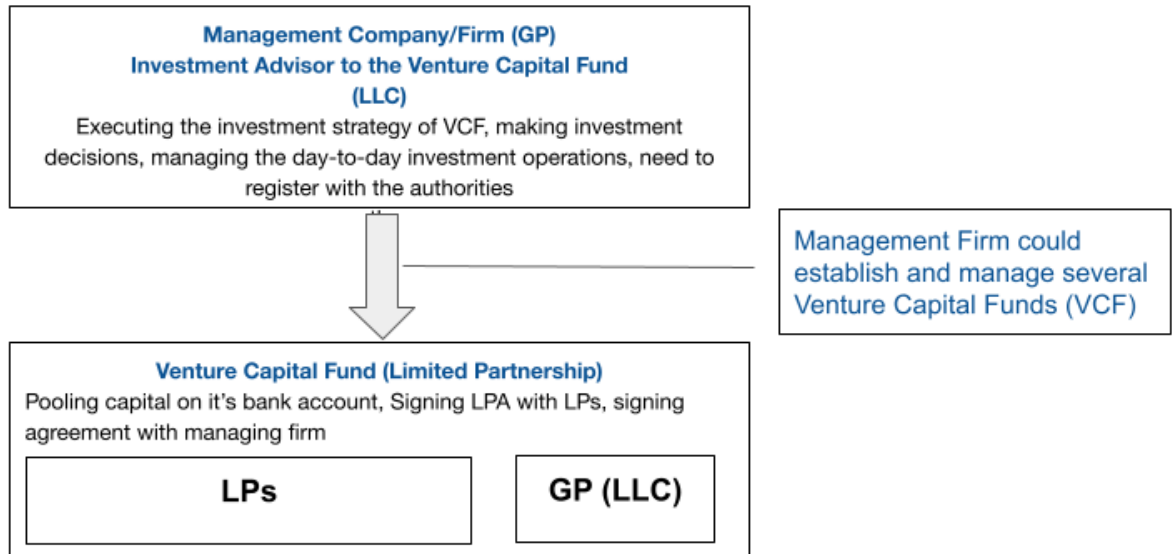
- **Commitment Amount:** The total amount of capital each LP agrees to commit to the fund.
- **Capital Calls:** The method and process by which the GP can call capital from the LPs. This includes notice periods, the format of the call, and any penalties for late payment.
- **Default Provisions:** The consequences if an LP fails to meet a capital call. This can range from interest payments to forfeiture of partnership interests.
- **Distributions:** How and when profits are distributed back to LPs.

There is practice where GPs are asking capital call LPs in more predictable manner and it's for example twice per year.

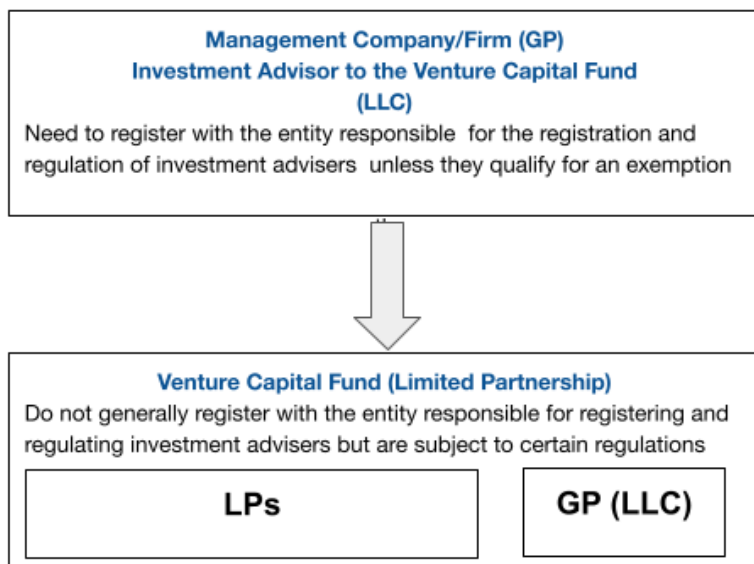




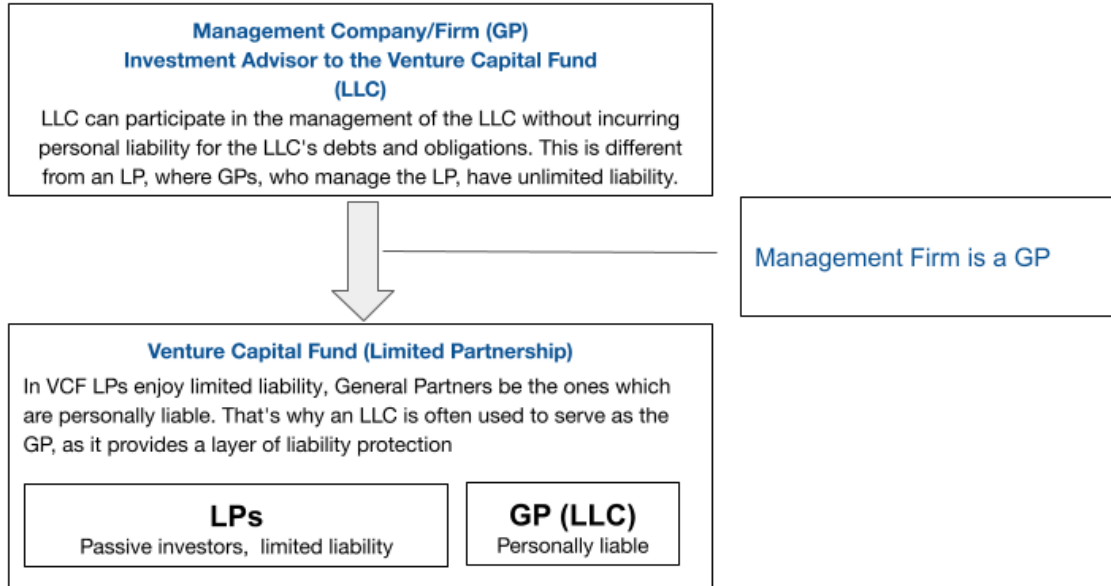
## Organizational Structure of Managing Firm (Investment Advisor) and Venture Capital Fund (VCF)



## Legal Structure of Managing Firm (Investment Advisor) and Venture Capital Fund (VCF)



## Operational Structure of Managing Firm (Investment Advisor) and Venture Capital Fund (VCF)



## Funding of Startups and Taxation

