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Exemptions

Newly Created Dodd-Frank Adviser Exemptions Are No Vacation from the Advisers Act: What You Need to Know regarding Applicable Regulatory Requirements and Best Practices

Contributed by Stephen H. Cohen, Loeb & Loeb LLP

Attention venture capital fund managers and small private fund advisers: newly created investment adviser exemptions are no vacation from regulatory requirements. The Securities and Exchange Commission (SEC) adopted final rules implementing new exemptions from the registration requirements of the Investment Advisers Act of 1940 (Advisers Act), in order to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) that create exemptions for advisers to venture capital funds and small private fund advisers. The new rules, Rule 203(l)-1, which defines a "venture capital fund" for purposes of the exemption and Rule 203(m)-1, which provides an exemption from registration for advisers with less than $150 million in private fund assets under management in the United States, went into effect July 21, 2011. Managers of funds in existence prior to July 21, 2011 that meet the definition of a "venture capital fund" and those who qualify as small private fund advisers (collectively, Exempt Reporting Advisers), need to file for an exemption by no later than March 30, 2012. Managers of newly formed funds, which are funds created after July 21, 2011, will need to take action within 60 days of forming a fund and qualifying for one of the exemptions.

Filing for an exemption is not the end of the regulatory story, however. Venture capital industry professionals and private fund advisers who expect that, once exempt, they can return to "business as usual" without giving any further thought to regulatory obligations may be surprised to discover that the exemptions from registration will not operate as an SEC "get out of jail free card." In fact, the word "exemption" is a misnomer, because intrinsic in the concept of "exemption from registration" is a world filled with compliance, record keeping, and reporting obligations, as well as exposure to SEC oversight and examination.

While Dodd-Frank exempts from registration venture capital fund managers that meet the requirements of Rule 203(l)-1 and small private fund advisers that meet the requirement of Rule 203(m)-1, the law does not exempt them from complying with the recordkeeping and reporting obligations of Advisers Act Section 204 and the provisions authorizing SEC inspections and examinations. For Exempt Reporting Advisers, this is a major and unexpected change, and they need to become informed about the regulatory landscape that lies ahead.

Reporting Requirements

Exempt Reporting Advisers must file an initial Form ADV, Part 1A (Uniform Application for Investment Adviser Registration and Report by Exempt Reporting Advisers) with the SEC, which will be made public through the IARD disclosure system. Specific sections of the Form ADV must be filled out and kept up to date on at least an annual basis, and in some cases more frequently. The disclosure items include:

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- Item 1, dealing with the identity of the fund manager.
- Item 2.B, the basis for SEC reporting by Exempt Reporting Advisers that would identify the venture capital exemption or the small private fund exemption.
- Item 3, setting forth the form of organization of the fund manager.
- Item 6, detailing the fund manager's other business activities.
- Item 7, dealing with financial industry affiliations and private fund reporting (*see* below for further details regarding private fund reporting). The purpose of disclosing the information regarding financial industry affiliations of the Exempt Reporting Adviser's affiliates is to identify areas in which conflicts of interest may occur between the adviser and its clients.
- Item 10, requiring all control persons be identified and information filled out on Schedules A, B, C and D.
- Item 11, requiring a thorough disclosure of the disciplinary histories of the fund manager and its officers, directors, and entities listed on Schedules A and B.

Exempt Reporting Advisers must update the information described above on the Form ADV at least annually, Items 1, 3, and 11 promptly as information changes, and Item 10 promptly if the information materially becomes inaccurate.

– Specific Reporting Requirements regarding Venture Capital Funds and Small Private Funds

Under Advisers Act Rule 204-4, an Exempt Reporting Adviser must provide detailed information about each fund it advises. This information is set forth on Item 7.B and related Section 7.B of Schedule D of the Form ADV and includes the following:

- Basic identifying information about the fund, including its name, jurisdiction of formation, the name of the fund's general partner, directors, or other persons serving in a similar capacity.
- Whether the fund has a foreign registration and the name of the foreign regulatory authority to which the fund is subject, if applicable.
- The Investment Company Act of 1940 exemption upon which it relies.
- Operation and structural information, including whether the fund is a part of a master-feeder structure or is a fund of funds.
- The investment strategies that best describe the fund.
- The gross asset value of the fund; certain limited information about the fund's investors, including the total number of beneficial owners; the percentages of the fund owned by the fund manager or related persons, by fund of funds, and by non-U.S. persons; and the minimum investment commitment required of each investor.
- Information about the fund's service providers, including auditors, prime brokers, custodians administrators and marketers (including, among others, placement agents and solicitors).

Recordkeeping Requirements

Although Exempt Reporting Advisers are subject to recordkeeping requirements, the SEC has not yet addressed the details of what these requirements will entail, leaving it to future rulemaking. This creates an uncertainty for Exempt Reporting Advisers as to what records they should keep now in order to comply with the future rules. The SEC does not always create a grandfathering provision that recognizes the status quo prior to the implementation of a new rule. To avoid having to scramble once the SEC does publish its recordkeeping rules, Exempt Reporting Advisers may wish to consider maintaining their books and records in a manner consistent with the existing requirements for registered investment advisers. In addition to ensuring future compliance with the potential rules, an added benefit would be that, in the event the Exempt Reporting Adviser loses its exemption–or chooses voluntarily to register with the SEC, it will already have books and records that comply with the Advisers Act.

Compliance Obligations

Exempt Reporting Advisers are subject to Section 206, the antifraud provision of the Advisers Act. Sections 206(1) and 206(2) generally prohibit an investment adviser (including an Exempt Reporting Adviser) from employing a "device, scheme or artifice" to defraud clients or engaging in a "transaction practice or course of business" that operates as a "fraud or deceit" on clients. The following activities have been found to violate Sections 206(1) or 206(2):

- Failing to conduct agreed-upon due diligence on venture capital investments.
- Misrepresenting internal controls.
- Overstating performance results.
- Undisclosed bribery or "kickback" schemes.

Among the most important requirements of Sections 206(1) and 206(2) with which Exempt Reporting Advisers must comply is the necessity of making full and fair disclosure to clients or fund investors regarding matters that may have an impact on the fund manager's independence and judgment. While the amount and nature of the disclosure required depend on the facts and circumstances of each case, the duty of disclosure in situations

involving a potential conflict of interest is generally broader than under normal circumstances. For managers of venture capital funds and small private funds, these types of disclosures are generally made in the relevant offering documents, or in some cases, in the advisory agreement. Although these obligations have always been required of both venture capital and small private fund managers, the likelihood of the SEC bringing a cause of action for a failure to comply with these provisions increases substantially for an Exempt Reporting Adviser. A well thought-out compliance program can help enable the venture capital fund manager to comply with these antifraud provisions of the Advisers Act.

Exempt Reporting Advisers are subject to the pay-to-play restrictions under Advisers Act Rule 206(4)-5, and must ensure that neither they nor their personnel make improper political contributions in return for obtaining investments in the fund from government entities, whether directly or indirectly. They must adopt written policies and procedures that address the substantive requirements applicable to political contributions set forth in Rule 206(4)-5. In addition to the substantive requirements of the pay-to-play rule, an Exempt Reporting Adviser must maintain certain books and records regarding political contributions and payments.

Exempt Reporting Advisers to venture capital and small private funds must ensure continued compliance with Rule 203(l)-1 and Rule 203(m)-1, respectively. When the criteria set forth in Rule 203(l)-1 can no longer be met, for example, the fund can no longer hold itself out as pursuing a venture capital strategy or nonqualifying investments exceed 20 percent of the fund's capital commitments, the Exempt Reporting Adviser will immediately lose its exempt reporting status (unless it is able to meet another exemption) and must register as an SEC-registered adviser. The failure to comply with the components of Rule 203(l)-1 has such drastic and immediate consequences that an Exempt Reporting Adviser must create policies and procedures that enable it to monitor its compliance and ensure adherence to the rule. Similarly, when the criteria set forth in Rule 203(m)-1 can no longer be met by an increase in assets under management above the $150 million threshold, it will have 90 days after filing its annual updating amendment to register. However this 90-day grace period is only available if the small private fund adviser complied with the recordkeeping and reporting requirements for Exempt Reporting Advisers. A failure to maintain those requirements will disqualify the small private fund adviser from relying on the 90-day grace period and subject it to immediate registration requirements.

SEC Inspections

Lastly, and perhaps most importantly, for the first time Exempt Reporting Advisers are subject to inspection by SEC staff. While the SEC has stated that these exams will only be for cause–when prompted based on a tip, a complaint, or a referral from another agency or self-regulatory organization–the potential now exists for the SEC to examine an Exempt Reporting Adviser's books and records, reports and disclosures on Form ADV, the accuracy of disclosures to its clients and investors, and its overall compliance with the antifraud rules. The failure to satisfy the SEC during an exam could be costly and severely hinder the future ability of a venture capital fund or a small private fund to raise future capital from investors. An Exempt Reporting Adviser should consider developing a compliance program that enables it to successfully manage a potential SEC examination.

Conclusion

Advisers to venture or small private funds that plan on becoming an Exempt Reporting Adviser should now understand that advanced preparation is necessary and an assessment of their particular company's ability to fulfill the compliance, reporting and recordkeeping requirements under the Advisers Act should be a priority.

Mr. Cohen is a partner in the New York office of Loeb & Loeb LLP, where he focuses his practice on broker-dealer regulation and the securities markets. His clients include major international banks, domestic and foreign investment banks, full service and boutique brokerage firms, clearing firms, transfer agents and hedge funds. Mr. Cohen also heads the firm's Dodd-Frank Financial Reform Task Force, facilitating the registration and exemption process for private fund managers. scohen@loeb.com.