

## PROSKAUER ROSE LLP

### Memorandum

**To: The National Venture Capital Association**  
**From: Proskauer Rose LLP<sup>1</sup>**  
**Re: Background on Investment Adviser Registration**  
**Date: July 28, 2009**

### Introduction

Current legislative proposals from the Obama administration and from within the Senate and the House of Representatives would eliminate Section 203(b)(3) of the U.S. Investment Advisers Act of 1940 (the “Advisers Act”), which is a statutory exemption commonly relied upon by investment advisers to private investment funds to remain exempt from registration with the SEC as an investment adviser (the “Private Adviser Exemption”). If any of these proposals are successful in eliminating the Advisers Act exemption, virtually all investment advisers to private investment funds (including venture capital funds) will be required to register with the SEC.

This memorandum provides a general overview of the circumstances in which investment advisers are required to be registered under the Advisers Act, how registration is accomplished, and the principal substantive business and operational requirements of the Advisers Act applicable to investment advisers to venture capital funds.

*Please note that this memorandum is not intended to provide a complete description of all compliance issues and responsibilities of investment advisers pursuant to the Advisers Act and other applicable state and federal securities laws.*

### Investment Adviser Registration

The Advisers Act defines the term “investment adviser” broadly to include, “any person who, for compensation, engages in the business of advising others . . . 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. . . .” As such, the definition of investment adviser encompasses virtually any manager of a venture capital fund.<sup>2</sup>

<sup>1</sup> Prepared by David Jones, Mary Kuusisto, Mike Suppappola and Luke Harris of Proskauer Rose LLP.

<sup>2</sup> While the management company to most venture capital funds would be the venture capital firm’s “investment adviser” for purposes of registration, this determination should be made in consultation with the venture capital firm’s legal advisors in consideration of a venture capital firm’s structure and particular circumstances.

In general, Section 203A of the Advisers Act provides that an investment adviser *may* register with the Securities and Exchange Commission (the “SEC”) if it has between \$25 and \$30 million of assets under management, and it *must* register with the SEC if it has greater than \$30 million of assets under management. Notwithstanding the foregoing, certain investment advisers (such as an investment adviser to a registered investment company) are required to register with the SEC irrespective of their total amount of assets under management. An investment adviser that does not register with the SEC may still be required to register with one or more state authorities.

### **The Private Adviser Exemption**

There are a number of statutory exemptions from the registration requirement available to persons whose activities would otherwise require them to be registered. Of most relevance to venture capital firms is the Private Adviser Exemption, which is commonly relied upon today by investment advisers to private investment funds.

The Private Adviser Exemption exempts from registration any investment adviser that (i) during the previous twelve months had fewer than fifteen clients, (ii) does not hold itself out generally to the public as an investment adviser, and (iii) does not advise either an investment company registered under the Investment Company Act of 1940 (the “Company Act”) or a business development company.

One key component of the Private Adviser Exemption is compliance with the “no holding out” requirement. An investment adviser which holds itself out to the public in the United States as an investment adviser will not be eligible to rely on the Private Adviser Exemption, regardless of whether it has fewer than fifteen clients.

Another key component of the Private Adviser Exemption is that the investment adviser must have had no more than fourteen “clients” during the previous twelve month period. Generally speaking, for a typical venture capital firm, an investment adviser must count each venture capital fund it advises for compensation as a “client,” but does not need to count the individual investors in each fund toward the fifteen client threshold.

If any of the current legislative proposals discussed above are successful in eliminating the Private Adviser Exemption, virtually all investment advisers to venture capital funds (indeed, to all private investment funds) with \$30 million or more in assets under management will be required to register with the SEC.

### **Registration Procedures**

Application for registration as an investment adviser is submitted to the SEC on Form ADV. Part I of Form ADV is filed electronically with the SEC through the Investment Adviser Regulatory Depository (the “IARD”) system maintained by the Financial Industry Regulatory Authority (“FINRA”). Part II of Form ADV is not required to be filed through the IARD, but must be completed and retained by each investment adviser and delivered to clients as described below.

To establish an account with the IARD, an applicant must complete certain “Entitlement Forms” and submit them to FINRA. Upon receipt of the applicant’s forms in proper order, FINRA creates user accounts for the account administrators (“AAs”) designated by the applicant in its application and contacts the AAs with the applicant’s user IDs and passwords for accessing IARD. Applicable forms and information for establishing an IARD account can be obtained online at the IARD homepage (<http://www.iard.com>). Answers to frequently asked questions can also be found at the section of the SEC website dealing with the IARD system (<http://www.sec.gov/divisions/investment/iard/iardfaq.shtml#tsched>).

Part I of Form ADV requests certain basic information relating to the investment adviser, such as the investment adviser’s jurisdiction of incorporation and principal place of business, details concerning the ownership and control of the investment adviser, the U.S. state jurisdictions where the investment adviser is licensed or registered, and whether the investment adviser or an affiliate has been involved in any material civil, criminal or administrative legal proceedings.

Once the IARD account is established, the applicant can create and amend Part I of Form ADV (and other related forms) and pay associated fees over the Internet. Assuming that the Form ADV that is submitted meets all SEC requirements, the SEC will usually mail the applicant an order approving the registration, typically within 45 days, and will also notify the applicant through IARD that the registration has been approved.

The IARD system is also used to file annual updating amendments to Form ADV Part I which must be filed within 90 days of the registered investment adviser’s fiscal year end. Part I of Form ADV must be updated in this manner to reflect any changes that may have occurred during the fiscal year. The registered investment adviser must also renew its registration and any state notice filings (and pay related fees) via the IARD system on an annual basis.

Part II of Form ADV is generally provided to a registered investment adviser’s potential and existing clients (in the case of a venture capital fund manager, each venture capital fund it manages is a “client” for purposes of Form ADV delivery), as well as to the venture capital funds’ potential and existing investors as discussed later in this memorandum. Part II requires fairly detailed disclosures relating to the operations, business practices and potential conflicts of interest of the registered investment adviser including:

- the nature of the registered investment adviser’s services and fees charged, including the investment objectives, strategies and associated risks of the venture capital funds advised by the investment adviser and basic information regarding the management fees and carried interest applicable to each such fund;
- the methods of securities analysis and sources of information utilized in advising venture capital funds and formulating investment recommendations (for example, prospectuses, research reports and/or on-site visits of portfolio companies);

- any affiliations the registered investment adviser has with other entities in the securities industry, including banks, insurance companies, broker-dealers or other financial institutions, as well as any conflicts of interest related thereto;
- whether the registered investment adviser has discretion to select brokers when liquidating securities distributed in kind or when otherwise trading securities on behalf of a venture capital fund and, if so, how the registered investment adviser allocates brokerage transactions among broker-dealers; and
- the educational and business background of the persons providing investment advice and other control persons of the registered investment adviser.

### **Advisers Act Compliance Requirements for Registered Investment Advisers**

In addition to requiring registration with the SEC, the Advisers Act establishes a number of critical substantive requirements governing the operation of a registered investment adviser and the relationship between that registered investment adviser and its venture capital fund clients. The most significant of these requirements relate to performance fees (including carried interest), required disclosures to venture capital fund clients and their investors, investment advisory agreements, advertising by registered investment advisers, custody of venture capital fund assets, personal securities trading by partners, officers and employees of the investment adviser, compliance manuals, codes of ethics, and recordkeeping requirements. Each of these requirements is summarized briefly below.

- Performance Fees. Section 205(a)(1) of the Advisers Act prohibits advisory contracts that provide for compensation based on a percentage of the capital gains or capital appreciation in a client’s account, subject to certain exceptions. This limitation was designed to preclude registered investment advisers from subjecting client funds and securities to unnecessary speculation in order to increase fees to the registered investment adviser. Generally, a registered investment adviser may charge a performance fee only if the client (a “Qualified Client”) has \$750,000 under management with the registered investment adviser, has a minimum net worth of \$1,500,000, is a “qualified purchaser” as defined under the Company Act, or is a non-U.S. person. All of the investors that directly or indirectly bear a performance fee related to a venture capital fund operating pursuant to the “100 beneficial owner” exemption under Section 3(c)(1) of the Company Act must meet the Qualified Client standard.<sup>3</sup>

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<sup>3</sup> For most purposes of the Advisers Act, a venture capital adviser’s “client” is the venture capital fund it manages and *not* the investors in the venture capital fund. However, one exception to this rule is found in Rule 205-3(b) of the Advisers Act, which states that each equity owner of a private investment fund relying on the Section 3(c)(1) exemption from Company Act registration is deemed a “client” for purposes of the performance fee prohibition. Accordingly, each investor in a venture capital fund relying on the Section 3(c)(1) exemption must be a Qualified Client to comply with the Advisers Act performance fee restrictions.

Although a venture capital fund's carried interest is a share of the fund's cumulative net profits and not a "fee" for services, the Advisers Act treats carried interest in the same manner as a performance fee. Further, while almost all venture capital funds limit fund offerings to accredited investors pursuant to the Regulation D safe harbor of the Securities Act of 1933 (the "Securities Act"), some venture capital funds do not offer interests exclusively to Qualified Clients.<sup>4</sup> *Accordingly, unless a "grandfathering" exemption is included in the new investment adviser legislation, Advisers Act registration could cause significant fee restructuring issues for a substantial number of existing venture capital funds.*

- **SEC Examinations.** The SEC will conduct periodic examinations of registered investment advisers, which may be announced in advance or unannounced. During an examination, the SEC inspection staff will look closely at, among other things, the registered investment adviser's internal controls, compliance policies and procedures, annual review documentation and books and records. The SEC staff will also typically request certain e-mail correspondence of the registered investment adviser's portfolio managers and/or control persons over the course of a specific time period (typically ranging anywhere from a few months to one year prior to the examination) in a searchable format.<sup>5</sup> SEC examinations may last anywhere from a few days to a few months depending on the size of the firm, the results of prior inspections and the firm's risk profile.
- **Compliance Program and Appointment of a Chief Compliance Officer.** Advisers Act Rule 206(4)-7 requires all registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws, to review the policies and procedures annually for their adequacy and the effectiveness of their implementation, and to designate a chief compliance officer (a "CCO") to be responsible for administering the policies and procedures.

The CCO selected by the registered investment adviser must be competent and knowledgeable regarding the Advisers Act and generally empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. Generally, a CCO's competence and knowledge must encompass the Advisers Act and other relevant federal securities laws and be informed by an ongoing assessment of the firm's business model, as well as

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<sup>4</sup> As a practical matter, many venture capital funds require each investor to represent that it is an "accredited investor" (for purposes of the Securities Act) and a "qualified purchaser" (for purposes of Section 3(c)(7) of the Company Act) in the venture capital fund's subscription agreement. As discussed above, if the investor can represent that it is a qualified purchaser, then it is automatically deemed a Qualified Client. If the venture capital fund relies on the Section 3(c)(1) exemption of the Company Act and only requires a representation that the investor is an "accredited investor," then the venture capital fund would need to ensure that any investor in the fund that directly or indirectly bears carried interest can also represent that it is a Qualified Client. If it cannot so represent, restructuring of carried interest allocations may be required.

<sup>5</sup> See also below under "Recordkeeping."

recent regulatory trends, in order to identify existing and emerging compliance risk areas. In equally general terms, the authority CCOs possess may give rise to liability for failure to properly supervise a firm's compliance program. This will necessitate an effective compliance system based on checks and balances that will provide multi-layers of oversight to ensure that there is (i) a clear delineation of compliance-related duties and (ii) independent oversight that these duties are being performed. Although not explicitly required by the Advisers Act, the SEC may expect certain registered investment advisers to hire a full-time CCO (depending on the size of the firm and the complexity of its business model).

Although the SEC does not require that the policies and procedures contain specific elements, it has indicated that it expects that written policies and procedures would address, at a minimum and to the extent they are relevant to the registered investment adviser: (i) portfolio management procedures regarding the investment processes of a registered investment adviser; (ii) proprietary trading of the registered investment adviser and personal securities trading by the registered investment adviser's supervised persons; (iii) regulatory issues, including procedures to ensure the accuracy of disclosures made to clients, investors and regulators; (iv) safeguarding of client funds and assets (*e.g.*, bank accounts and signatory authority over client funds and securities); (v) accurate creation and maintenance of required books and records under the Advisers Act; (vi) advertising and marketing practices; (vii) processes to value client holdings and assess fees based on those valuations; (viii) safeguards for the privacy protection of client records and information; (ix) disaster recovery and business continuity plans; (x) insider trading safeguards; and (xi) anti-money laundering efforts.

- Codes of Ethics. Advisers Act Rule 204A-1 requires all registered investment advisers to adopt a code of ethics (a "Code"). The Code must set forth, among other things: (i) standards of conduct expected of advisory personnel; (ii) a system of pre-clearance for investments in initial public offerings and private placements by the registered investment adviser's supervised persons who have access to information regarding the registered investment adviser's recommendations of purchases or sales of securities or portfolio holdings ("Access Persons"); (iii) a requirement that all violations of the Code be promptly reported to the CCO or his or her designee; and (iv) a requirement that Access Persons and certain of their family members periodically report their personal securities transactions and holdings in securities (other than certain classes of securities, such as U.S. government securities, money market instruments, and shares or units in unaffiliated mutual funds). Reports in relation to securities holdings must be submitted to the registered investment adviser's CCO (or his or her designee) at the time that the supervised person becomes subject to the reporting obligation, and on an annual basis thereafter. Reports in relation to securities transactions must be submitted on a quarterly basis. The registered investment adviser must provide each supervised person with a copy of its Code (and any amendments thereto) and must obtain each supervised person's written acknowledgement of receipt of that copy.

- Form ADV and Periodic Filings. Rule 204-3 of the Advisers Act requires all registered investment advisers to furnish each advisory client or prospective advisory client with a written disclosure statement that provides basic information concerning the registered investment adviser, its operations, and its principals.<sup>6</sup> This statement may be either a copy of the registered investment adviser’s current Form ADV Part II (including the schedules containing supplementary responses to the questions in Form ADV Part II) or another written document containing the information in the registered investment adviser’s current Part II of Form ADV. In addition, a registered investment adviser is required, annually and without charge, to deliver, or offer in writing to deliver upon written request to each of its clients, a copy of Form ADV Part II. Registered investment advisers are also required to file an updated Form ADV Part I with the SEC on at least an annual basis within 90 days of the end of each fiscal year of the registered investment adviser.
- Custody. In general, Advisers Act Rule 206(4)-2 requires, among other things, that a registered investment adviser that has custody of client funds or securities maintain such funds or securities with a qualified custodian.<sup>7</sup> A “qualified custodian” includes, among other institutions, a bank, savings association, and a registered broker-dealer. While the custody rules are extremely technical and complex, most investment advisers to venture capital funds comply with the custody rule by (i) subjecting each venture capital fund they manage to an annual audit and (ii) distributing audited financial statements to all limited partners or other beneficial owners within 120 days of the end of its fiscal year (or 180 days of the end of its fiscal year for a registered investment adviser that manages a “fund of funds”).<sup>8</sup>
- Advertisements. Advisers Act Rule 206(4)-1 and SEC interpretations thereof prohibit registered investment advisers from engaging in a variety of advertising practices, including the following: (i) referring to any testimonials regarding the registered investment adviser; (ii) disclosure of past specific securities

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<sup>6</sup> The SEC has recently indicated that an adviser to a private investment fund is not required to deliver Form ADV Part II to each investor in the fund because an “investor” is not a “client” for certain purposes of the Advisers Act. Nevertheless, Advisers Act Rule 206(4)-8 generally requires an adviser to make full disclosure of all conflicts of interest and other material facts to fund investors. Accordingly, practitioners generally recommend that registered investment advisers to venture capital funds deliver Form ADV Part II to existing and prospective fund investors to best safeguard against potential disclosure-related violations of the Advisers Act anti-fraud provisions. Moreover, new legislative proposals (if passed) would give the SEC authority to change the meaning of “client” for various Advisers Act rules in the future, including Rule 204-3 of the Advisers Act.

<sup>7</sup> Neither a registered investment adviser or a venture capital fund would qualify as a “qualified custodian” under the custody rules.

<sup>8</sup> On May 14, 2009, the SEC proposed amendments to the custody rule that would require, among other things, that all registered investment advisers submit to an annual “surprise” examination by an independent public accountant, which would include examination of privately placed and uncertificated securities held by venture capital funds.

recommendations (e.g., portfolio company investments) without disclosing all past recommendations or investments made by the registered investment adviser over the course of the prior one-year period; and (iii) providing clients or investors with a track record of the registered investment adviser's performance unless all returns are calculated net of investment advisory fees, performance fees (including carried interest) and expenses.

- Assignment. Section 205(a)(2) of the Advisers Act requires that any contract for advisory services entered into between a registered investment adviser and a client contain a provision prohibiting the registered investment adviser from assigning the contract without the consent of the client, either directly or through a sale or transfer of a "control" interest in the registered investment adviser. Under current SEC rules and interpretations, the registered investment adviser's "client" is the private investment fund, and therefore the fund must provide the consent. While the SEC has not explicitly addressed the issue of how a venture capital fund may consent to Advisers Act conflicts, current industry practice is generally to obtain the consent of the fund's advisory committee or another independent board on behalf of the fund. In certain circumstances, the registered investment adviser may need to obtain the consent of a certain percentage of investors.
- Recordkeeping. Advisers Act Rule 204-2 sets forth the books and records that registered investment advisers must maintain. The CCO and at least one member of the professional staff of a registered investment adviser should be fully familiar with this rule, which lists approximately twenty categories of records to be maintained, and with all operating procedures for complying with the recordkeeping rule. Any and all of the required books and records are subject to inspection by the SEC at any time, without notice. All of these records must be kept in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on a particular record. For the first two years after the end of the last fiscal year an entry was made, such records must be kept in an appropriate office of the registered investment adviser.

Advisers Act Rule 204-2(g) requires that registered investment advisers "arrange and index" electronic books and records in a "way that permits easy location, access, and retrieval of any particular record." The SEC, however, has generally been silent on what its expectations are with respect to reasonable procedures for archiving electronic books and records. As discussed in "SEC Examinations" above, SEC examiners now routinely request prompt production of all email correspondence sent or received by certain principals of a registered investment adviser in an easily searchable format.

As a result of the uncertainty regarding SEC expectations for retaining email in compliance with Advisers Act electronic retention requirements (as well as the administrative burden inherent in reviewing individual emails prior to deletion), many registered investment advisers choose to archive all email correspondence for a period of five years. Moreover, it has become increasingly common for

registered investment advisers to hire third party electronic document service providers to assist with archiving all email correspondence of the advisory firm and promptly responding to SEC requests for production of emails during an examination.

### **Advisers Act Compliance Requirements for Registered *and* Unregistered Investment Advisers**

Certain sections of the Advisers Act also apply to both registered *and unregistered* investment advisers, including unregistered investment advisers to venture capital funds (*i.e.*, they apply currently to investment advisers to venture capital funds regardless of whether any of the legislative proposals are adopted). Further, unregistered investment advisers should be aware that violations of Advisers Act rules that “technically” apply only to registered investment advisers (*e.g.*, advertising) can still be enforceable against unregistered advisers pursuant to the anti-fraud provisions of the Advisers Act in certain circumstances.<sup>9</sup>

- **Supervision of Employees.** Section 203(e)(6) of the Advisers Act requires that an investment adviser use reasonable efforts to supervise the activities of its employees, agents and associated persons with a view to preventing violations of the securities laws. An investment adviser will be deemed to have met its obligations under this provision if: (1) it establishes procedures and a system for their implementation that reasonably would be expected to prevent and detect violations of the law (see “Compliance Program” above) and (2) it has reasonably discharged its duties under such procedures without reasonable cause to believe that its procedures and systems were not being complied with. Connected with the duty to supervise is the requirement of Section 204A of the Advisers Act that obligates investment advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent misuse of material inside information which may come into the possession of an investment adviser.
- **Fiduciary Obligations.** A fundamental element of the relationship between an investment adviser and its clients is the fiduciary duty owed by the investment adviser to its clients. A fiduciary has a special obligation to discharge its duties solely in the best interests of its clients. As a fiduciary, the investment adviser must be sensitive not only to intentional wrongdoing, but also to unintentionally rendering investment advice that is impartial or less than disinterested. In recognition of the fiduciary duties owed by investment advisers to their clients, the staff of the SEC has adopted specific rules under the Advisers Act proscribing certain activities in order to prevent fraud and to limit potential conflicts of interest.

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<sup>9</sup> Section 206 of the Advisers Act, which applies to both registered and unregistered investment advisers, generally prohibits an investment adviser from engaging in any transaction or course of business that operates as a fraud or deceit on any current or prospective “client.” Rule 206(4)-8 of the Advisers Act applies this to private investment fund “investors” as well.

For example, Section 206(3) of the Advisers Act provides that an investment adviser may not (i) acting as principal for its own account, knowingly sell any security to or purchase any security from a client or (ii) knowingly effect any sale or purchase of any security for the account of a client while acting as a broker for a third party (an agency cross transaction), without in either case disclosing to the client, in writing, the capacity in which the investment adviser is acting and obtaining the client's consent. This prohibition against self-dealing and acting in transactions in which the investment adviser has divided loyalties overrides any investment discretion conferred on the investment adviser by contract. Generally, clients must consent to each proposed agency cross or principal transaction.

Rule 206(3)-2 allows clients to consent to agency cross transactions in advance, provided that certain prerequisites are fulfilled. No such relief is available for principal transactions, which requires the client's consent on a transaction-by-transaction basis. Venture capital firms that "warehouse" portfolio investments with the investment adviser (or another entity under common control with the management company) may engage in a principal transaction when the investment is eventually transferred to the venture capital fund. The consent of the venture capital fund "client" is typically obtained as described in "Assignment" above.

The SEC also requires an investment adviser to make certain disclosures concerning its legal and disciplinary history in certain situations. Any legal or disciplinary event that is material to the evaluation of an investment adviser's integrity or ability to meet its obligations is required to be disclosed to potential clients and investors. Under Rule 206(4)-4, criminal convictions for felonies or misdemeanors or adverse civil court judgments connected with investment-related activities will generally be regarded as material.

We hope you have found this introduction to the Advisers Act useful. Please do not hesitate to contact David Jones ([djones@proskauer.com](mailto:djones@proskauer.com)), Mary Kuusisto ([mkuusisto@proskauer.com](mailto:mkuusisto@proskauer.com)) or Mike Suppappola ([msuppappola@proskauer.com](mailto:msuppappola@proskauer.com)), or any other member of your Proskauer Rose team, with any questions you may have with respect to the foregoing.