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SEC Actions Offer Lessons For Exempt VC Reporting Advisers

By **Adam Aderton, Justin Browder and Jonathan Tincher** (November 1, 2022)

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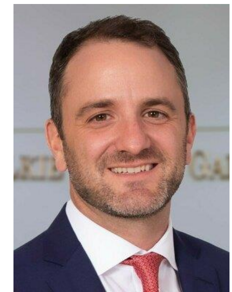

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A recent wave of enforcement actions against venture capital fund advisers reflects a continued expansion of the U.S. Securities and Exchange Commission's decadelong focus on SEC-registered private fund advisers to venture capital fund advisers who are not registered with the SEC, but who are, as these actions show, nonetheless at risk of SEC enforcement.

On Sept. 2, the SEC announced a settlement with venture capital fund adviser Energy Innovation Capital Management LLC for allegedly overcharging two of its funds due to errors in its management fee calculations.[1]

On Sept. 12, the SEC charged two related SparkLabs Global Ventures Management LLC fund advisers for allegedly making unauthorized and undisclosed interfund loans.[2] Three days later, the SEC charged four investment advisers, including three venture capital fund advisers, with violations of the Investment Advisers Act pay-to-play rule.[3]

And, earlier this year, the SEC settled charges with a venture capital adviser, Alumni Ventures Group LLC, for allegedly making misleading statements about its management fees and engaging in interfund transactions in breach of fund operating agreements.[4]

In this article we analyze venture capital fund advisers' regulatory status as exempt reporting advisers, or ERAs, and the SEC's recent pursuit of ERA enforcement. We close with practical steps venture capital fund advisers and other ERAs may consider to mitigate regulatory risk arising from the SEC's focus on private funds.

ERA Regulatory Regime

Though subject to anti-fraud liability under Section 206 of the Advisers Act, most advisers to private funds historically relied upon an exemption from SEC registration that was available to advisers that managed 15 or fewer clients.

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act repealed this long-standing exemption and established certain narrower exemptions, including exemptions for advisers to venture capital funds and exemptions for private fund advisers with less than $150 million in assets under management.[5]

The SEC adopted rules to implement these exemptions in 2011.[6] Advisers that are eligible for and rely upon the exemptions adopted under Dodd-Frank are designated exempt reporting advisers because they are required to file abbreviated reports with the SEC using Form ADV.[7]

ERAs are exempted from many of the regulatory requirements imposed on registered investment advisers by rules adopted pursuant to the Advisers Act.[8]

For example, ERAs are not required to comply with the marketing rule, the custody rule, the proxy voting rule, the record-keeping rule or the compliance rule.

ERAs, however, must comply with certain other rules, including the pay-to-play rule, which regulates political contributions by investment advisers and their personnel.

ERAs also remain subject to the anti-fraud prohibitions in Section 206 of the Advisers Act and Rule 206(4)-8 thereunder, which prohibits advisers from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in the funds they manage.

In addition, ERAs may be examined by the SEC under Section 204 of the Advisers Act.

SEC Focus on Private Funds

According to SEC data, there are now more than 5,500 ERAs, an increase of more than 40% in the last five years.[9]

Moreover, the amount of venture capital fund assets managed by ERAs far exceeds that managed by registered investment advisers.[10] As the number of private funds and the value of assets managed by advisers to those funds has grown, the SEC increasingly has devoted resources to policing the private fund market.

Over the past decade, the SEC, through enforcement and other means, has addressed issues relating to expense allocation practices, application of management fee offset provisions, acceleration of consulting and advisory fees, unauthorized principal, agency and affiliate transactions, and disclosure of conflicts of interest, among others.[11]

The SEC's focus on private fund managers remains as acute as ever under Chair Gary Gensler, as illustrated by the proposal of an unprecedented rulemaking package that would impose significant changes on the private fund industry as a whole, including ERAs.[12]

Cases against ERAs over the years have involved conduct by a private fund manager that echoes these themes, including:

- Failing to offset consulting fees as required by fund documents;[13]

- Charging management fees following write-downs of private equity investments;[14]

- Neglecting to disclose certain conflicts of interest and to take measures required by fund documents;[15]

- Effecting cross trades between funds and engaging in principal transactions not in compliance with Section 206(3);[16] and

- Misappropriating investor funds under the guise of "advanced management fees."[17]

The SEC also has pursued a number of cases involving violations of the pay-to-play rule by ERAs, in addition to those that were just announced.[18]

For instance, in January 2017, the SEC settled with five ERAs out of a total of 10 investment advisers for pay-to-play rule violations.[19] In July 2018, the SEC settled pay-to-play rule violations with another ERA named EnCap Investments.[20]

The recent wave of enforcement actions against ERAs in 2022 is a further signal from the SEC that the issues pertinent to private fund managers will remain at the fore. In one case from this year, for instance, the ERA Energy Innovation Capital Management was found to have made a number of accounting calculation errors, including:

- Failing to make adjustments to its management fee calculations for individual portfolio company securities subject to write-downs;

- Inaccurately calculating management fees based on aggregated invested capital at the portfolio company level instead of at the individual portfolio company security level;

- Incorrectly including accrued but unpaid interest as part of the basis of the calculation of management fees for certain investments; and

- Failing to initiate a fund's post-commitment management fee period on the correct date.[21]

Takeaways

Although venture capital fund advisers and other ERAs are not subject to the same compliance obligations as registered investment advisers, the recent wave of enforcement actions shows that they nonetheless must take heed of the private fund-related issues and themes — e.g., fee and expense allocation, disclosure of conflicts of interest — that continue to be of intense interest to the SEC.[22]

To mitigate regulatory risks around these issues, venture capital fund advisers and other ERAs should review fund organizational and governing documents to evaluate whether fund practices and conflicts of interest are accurately and fully disclosed, and to ensure that operational and accounting practices align with the requirements under those documents.

In addition, ERAs should adopt and implement robust policies and procedures that are

tailored to their operations and are designed to prevent violations of the Advisers Act and the rules under that act applicable to ERAs.

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Disclosure: Aderton directly supervised the investigations that led to the enforcement actions involving Alumni Ventures Group, EDG Management Company, and Energy Innovation Capital Management that are referenced in this article.

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[1] Energy Innovation Capital Management, LLC, Advisers Act Release No. 6104 (Sept. 2, 2022).

[2] SparkLabs Global Ventures Management, LLC et al., Advisers Act Release No. 6121 (Sept. 12, 2022).

[3] SEC Charges Four Investment Advisers for Pay-To-Play Violations Involving Campaign Contributions, SEC Press Release (Sept. 15, 2022), https://www.sec.gov/enforce/ia-6126-s.

[4] Alumni Ventures Group, LLC and Michael Collins, Advisers Act Release No. 5975 (Mar. 4, 2022).

[5] Sections 403, 407 and 408 of the Dodd-Frank Act; Sections 203(l) and 203(m) of the Advisers Act.

[6] Rules 203(l)-1 and 203(m)-1 under the Advisers Act. See Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Advisers Act Release No. 3222 (June 22, 2011).

[7] ERAs are not required to deliver a Form ADV Part 2 brochure or brochure supplements to clients or prospective clients. See Rule 204-3 under the Advisers Act.

[8] ERAs of course remain subject to other applicable law. For instance, ERA status confers no exemption from the beneficial ownership reporting requirements imposed by Sections 13(d) and (g) of the Securities Exchange Act of 1934 and Regulation 13D-G thereunder. Venture capital fund advisers, moreover, may seek to have their funds qualify as "venture capital operating companies" for purposes of the Employee Retirement Income Security Act of 1974, as amended.

[9] See Information About Registered Investment Advisers and Exempt Reporting Advisers, July 2006 – October 2022 (modified Oct. 3,

2022), https://www.sec.gov/help/foiadocsinvafoiahtm.html.

[10] See Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Advisers Act Release No. 5955, 87 Fed. Reg. 16886 (Mar. 24, 2022), at 16935 (citing gross asset data for venture capital funds reported by registered investment advisers and ERAs ($290.4 billion and $996.3 billion, respectively)).

[11] See, e.g., Yucaipa Master Manager, LLC, Advisers Act Release No. 5074 (Dec. 13, 2018) (involving claims that a private fund adviser failed to disclose several financial conflicts of interests and misallocated fees and expenses); see also SEC Division of Examinations, Examination Priorities for 2015 (Jan. 13, 2015) (noting that EXAMS would continue to examine private fund advisers "in connection with fees and expenses"); SEC Division of Examinations, Examination Priorities for 2013 (Feb. 21, 2013) (announcing that EXAMS would seek out "undisclosed compensation and arrangements and the conflicts of interest that they present"); Director Andrew J. Bowden, SEC Division of Examinations, Spreading Sunshine in Private Equity, Address Before the Private Equity International Private Fund Compliance Forum 2014 (May 6, 2014); Co-Chief Julie M. Riewe, SEC Division of Enforcement, Asset Management Unit, Conflicts, Conflicts Everywhere, Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View (Feb. 26, 2015).

[12] See, e.g., Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Advisers Act Release No. 5955 (Feb. 9, 2022).

[13] Aisling Capital LLC, Advisers Act Release No. 4951 (June 29, 2018).

[14] EDG Management Company, LLC, Advisers Act Release No. 5617 (Oct. 22, 2020).

[15] Naya Ventures, LLC et al., Advisers Act Release No. 5461 (Mar. 12, 2020).

[16] Lone Star Value Management LLC and Jeffrey Eberwein, Advisers Act Release No. 5448 (Feb. 24, 2020). ERAs are permitted, however, to rely on the safe harbor provided in rule 206(3)-2 for effecting an agency cross transaction subject to section 206(3) of the Advisers Act.

[17] Burrill Capital Management, LLC et al., Advisers Act Release No. 4360 (Mar. 30, 2016).

[18] Penn Mezzanine Partners Management, L.P., Advisers Act Release No. 3858 (June 20, 2014); TL Ventures Inc., Advisers Act Release No. 3859 (June 20, 2014).

[19] 10 Firms Violated Pay-to-Play Rule By Accepting Pension Fund Fees Following Campaign Contributions, SEC Press Release (Jan. 17, 2017),https://www.sec.gov/news/pressrelease/2017-15.html.

[20] EnCap Investments LP, Advisers Act Release No. 4959 (July 10, 2018).

[21] Energy Innovation Capital Management, LLC, Advisers Act Release No. 6104 (Sept. 2, 2022).

[22] See, e.g., SEC Chair Gary Gensler, Prepared Remarks at the Institutional Limited Partners Association Summit (Nov. 10, 2021); SEC Division of Examinations, 2022 Examination Priorities (Mar. 30, 2022), at 11, https://www.sec.gov/files/2022-exam-priorities.pdf.