CLIENT ALERT

Recent Reminder for Exempt Reporting Advisers

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A settlement by the Securities and Exchange Commission ("SEC") with a California-based adviser (the "Adviser"),[1] which was recently approved by the federal district court for the Northern District of California, provides a reminder that exempt reporting advisers ("ERAs") are subject to the SEC's "cause" examinations, are required to comply with several of the provisions of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and owe fiduciary duties to their clients.

A person that is an investment adviser under Section 202(a)(11) of the Advisers Act is generally required to register with the SEC absent an exemption or exclusion. The Adviser relied on Section 203(l) of the Advisers Act to be exempt from registration.[2] ERAs are not required to register with the SEC and are not required to comply with certain provisions under the Advisers Act.[3] ERAs, however, remain subject to the anti-fraud provisions of the Advisers Act, which are at the core of the SEC's action against the Adviser.

1 *See* SEC Charges Technology Fund Adviser, Founder in Fraudulent Scheme *available at* https://www.sec.gov/news/press-release/2018-160.

2 Under Section 203(l) of the Advisers Act, an investment adviser can be exempted from registration if it advises solely one or more "venture capital funds." The term "venture capital fund" is defined in Rule 203(l)-1 under the Advisers Act. Another frequently used exemption is set forth under Section 203(m) of the Advisers Act, exempting investment advisers of private funds with assets under management in the United States of less than $150,000,000.

3 For example, ERAs are not required to comply with the custody rule set out in Rule 206(4)-2 under the Advisers Act and, while they are not subject to the recordkeeping requirements of Rule 204-2 under the Advisers Act, they must maintain such records and submit such reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors (*see* SEC Release No. IA-4839; pg. 5 and fn. 9).

In particular, the SEC's action against the Adviser involved the following allegations:

(a) In addition to raising and managing private funds that had the objective of investing in early-stage technology companies, the Adviser sought to create other business ventures. Beginning in 2015, the Adviser started misusing the funds' money and overcharging fees to the private funds not in accordance with their governing documents in order to finance such other personal business ventures without disclosing these events to the investors.

(b) The Adviser created the false appearance that the money was used for legitimate fund expenses or investments or had otherwise been paid back.

The SEC alleged that the Adviser violated Sections 206(1) and 206(2) of the Advisers Act by engaging in acts, practices, and courses of business that were fraudulent, deceptive, or manipulative, and violated Section 206(4) of the Advisers Act and Rule 206(4)-8 under the Advisers Act by making untrue statements of material fact or omitting to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading to any investor or prospective investor in a fund managed by the Adviser, and otherwise engaged in acts, practices, or courses of business that were fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in a fund managed by the Adviser. In its complaint, the SEC underlined how the Adviser repeatedly breached its fiduciary duties to its clients and confirmed the SEC's view that the Adviser "owed the Funds fiduciary duties of utmost good faith, loyalty, and care to make full and fair disclosure to them of all material facts concerning the Funds, including any conflicts or potential conflicts of interests, as well as the duty to act in the Funds' best interests, and not to act in [the Adviser's] own interests to the detriment of the Funds."[4] Without admitting or denying the allegations in the SEC's complaint, the Adviser agreed to settle the charges. The settlement was approved by the federal district court for the Northern District of California, and the amount of disgorgement and civil money penalties is subject to briefing and decision by the court. The Adviser also agreed to be barred from the brokerage and investment advisory business with a right to reapply after five years.[5]

Notwithstanding the facts alleged therein, this action remains a reminder to ERAs that, while they may be dispensed from complying with certain rules of the Advisers Act, they remain subject to some of the most fundamental rules and examination by the SEC,[6] particularly in the event there are allegations of breach of fiduciary duties or violation of the anti-fraud provisions of the Advisers Act. It is prudent to have comprehensive policies and procedures in place that are designed to prevent violation of the Advisers Act and the rules under the Advisers Act that are applicable to ERAs,

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[4] *See* SEC v. Rothenberg, et al., Paragraph 84.

[5] In the Matter of Michael B. Rothenberg, Release No. IA-5058 (Oct. 19, 2018).

[6] The SEC has also settled several enforcement actions against ERAs in the recent past alleging violations of the SEC's "pay-to-play" rule. *See, e.g.*, In the Matter of EnCap Investments L.P., Release No. IA-4959 (July 10, 2018).

including a process of reviewing marketing materials so that they adequately address all material risks and conflicts, which were at the center of other enforcement actions brought by the SEC in the recent past.

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

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