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INVESTMENT MANAGEMENT SERVICES

Fund Registration Primer

There is one question that often confronts venture capital firms as they grow more successful and encounter new opportunities: Should we register with the Securities and Exchange Commission (SEC)? While there is no one-size-fits-all response, and each firm will decide based on its own set of facts and circumstances, the current regulatory environment and the SEC's supercharged agenda are key factors to consider in the face of this question today. In this post, we briefly review the registration and exemption analysis applicable to most of our VC clients and highlight the key benefits and costs of becoming a registered investment adviser (RIA).

Registration basics for VC firms

Under the Investment Advisers Act of 1940 (Advisers Act), an investment adviser is any person who – for compensation – engages in the business of providing advice to others regarding securities. With the exception of family offices and corporate venture capital firms (CVCs), most VC firms will meet the definition of investment adviser. Anyone who falls within the definition of investment adviser is required to register unless an exemption applies. The main exemption for VC firms is the venture capital adviser exemption, although smaller firms, especially when first starting out, also may rely on the private fund adviser exemption.

The venture capital adviser exemption exempts from registration investment advisers that only advise one or more venture capital funds. The Advisers Act defines a venture capital fund as a type of private fund that represents to investors that it pursues a venture capital strategy, provides redemption rights only in extraordinary circumstances, does not borrow more than 15% of its aggregate capital contributions and uncalled capital commitments, and holds no more than 20% of its assets in nonqualifying investments (often referred to as the 20% basket), with the remaining 80% limited to investments in qualifying portfolio companies. Cash and cash equivalents do not count toward the 20% basket. A private fund is an investment vehicle that is not offered to the general public and is limited either to 100 beneficial owners or to beneficial owners that are qualified purchasers (which includes entities with \$25 million in investments and individuals with \$5 million in investments).

The private fund adviser exemption exempts from registration investment advisers that solely advise private funds and have less than \$150 million in gross assets under management – also known as regulatory assets under management (RAUM) – across all their funds. While subject to

a cap on its RAUM, a private fund adviser is not limited to advising venture capital funds and can advise any type of private funds, including private equity, crypto, hedge and others. A VC firm can rely on one or both of these exemptions, although it will likely outgrow the private fund adviser exemption over time. At that point, unless all of its clients are private funds that meet the venture capital fund definition, the adviser will need to register with the SEC. An adviser that relies on either exemption is referred to as an exempt reporting adviser (ERA). ERAs are required to file portions of the Form ADV Part 1A with the SEC and comply with limited requirements under the Advisers Act, and they are subject to examination by the Division of Examinations. However, they are not “registered” with the SEC.

What are the benefits of registering?

The biggest benefit of registering is flexibility. Advisers that rely on the venture capital adviser exemption or the private fund adviser exemption can find themselves forgoing certain opportunities or investment structures, negotiating less favorable terms, or taking on risk and dealing with uncertainties. They have to make a choice between the expensive and time-consuming process of registering and the regulatory burden that comes with it, or limit themselves to ensuring all their funds – including any special purpose vehicles (SPVs) they manage – meet the venture capital fund definition (including with respect to the 20% basket) or stay below \$150 million of RAUM.

Perhaps the most significant limitation for venture capital advisers is the cap on nonqualifying investments. In general, qualifying investments are limited to equity investments acquired directly from private operating companies. Debt securities, securities acquired in secondary transactions (including from founders and company employees), public company securities, cryptocurrencies and interests in other venture capital funds are among the common nonqualifying investments that need to fit in the 20% basket. By registering, a venture capital adviser would no longer be constrained by the 20% basket, which, in addition to freeing up capacity in its main funds for nonqualifying investments, also can prove especially impactful on the use and nature of SPVs that invest in such nonqualifying investments. Registering also would mean that the adviser could advise funds that borrow in excess of the 15% limit or permit investors to redeem outside of extraordinary circumstances.

Registration also allows increased flexibility to take on non-private fund clients, such as separately managed accounts, family offices and employee funds that are not private funds. For firms looking to explore new business lines and different asset classes, or enter into joint ventures, registration may provide much-needed latitude.

Finally, some firms may find that certain investors are more willing to commit to a fund advised by a RIA than an ERA. While registration does not impose a heightened standard of fiduciary duty

(ERAs are subject to the same standard of conduct as RIAs), it does impose a host of additional rules and requirements on the adviser that are designed to protect investors and provide additional information to the SEC. For some investors, this may be a factor they consider when choosing an investment adviser firm.

What are the downsides of registering?

While registration opens up new opportunities by removing regulatory constraints and offering flexibility in its place, it also imposes significant time and money costs. One of the first impositions of registration is the requirement to appoint a chief compliance officer (CCO) and implement a compliance program tailored to the RIA's business. These days, there are a plethora of compliance consultants who can assist with the development of a compliance program and also can conduct training sessions. There also are various compliance tools to assist with the collection, approval and oversight functions. What is important for firms to understand, however, is that the mere adoption of a compliance program will not be adequate. RIAs are expected to have a dynamic compliance program that adapts to changes in their business and organization, as well as developments in the law and market.

Becoming an RIA will mean greater scrutiny by the SEC. While ERAs are subject to examination and do get examined, RIAs are much more likely to undergo an examination. As a rule of thumb, RIAs should expect to be examined within their first year of registration and approximately once every seven years thereafter. During an examination, SEC staff will rigorously evaluate an adviser's compliance with the myriad of legal and regulatory requirements, including many that are based on fiduciary duty principles and disclosures to investors regarding conflicts of interest. Most examinations will result in the adviser receiving a deficiency letter that lists the areas where the adviser falls short, although some can and do get referred to the Division of Enforcement.

A firm that registers will become subject to various new rules under the Advisers Act, including the code of ethics rule, custody rule, marketing rule and recordkeeping rule. Each of these rules involves pain points that a new RIA will need to cope with. For example, the code of ethics rule requires senior executives and certain other personnel to submit quarterly transaction reports and annual holdings reports for their personal securities accounts and to preclear transactions in private placements and initial public offerings. The marketing rule requires deal-level net returns to be shown with equal prominence when deal-level gross returns are shown (something firms typically do not do and find meaningless), places limitations on the ability to use a track record achieved at a prior firm, and triggers disclosure and oversight requirements when engaging a placement agent. The custody rule requires stub year audits for funds that launch at the end of the year, irrespective of costs and investors' consent to extended audits, while the recordkeeping rule requires RIAs to manage how employees use off-channel communications like text messages, WhatsApp and other direct messaging applications. (Please note that the above is not

intended to summarize these rules or their numerous challenges, which is beyond the scope of this post.)

In addition, RIAs are subject to statutory requirements under the Advisers Act, pursuant to which they may be required to obtain investor consent when there are changes to their ownership structure. The addition or removal of a person who owns more than 25% of a RIA's voting stock can result in a deemed assignment of an advisory contract requiring consent. Moreover, for RIAs to receive performance-based compensation, their investors must be qualified clients (which may require investors to satisfy a net worth standard that is more than double what they need to satisfy for a fund managed by an ERA).

RIAs also are subject to additional reporting requirements. First, rather than completing just portions of Part 1A of the Form ADV as ERAs do, RIAs must complete the entire Part 1A, as well as Part 2A (the brochure) and Part 2B (the brochure supplement). While these additional sections require more time and attention to complete, once prepared, they are typically not as time-consuming to update and keep current. Second, RIAs must file a Form PF with the SEC, a confidential filing that collects information about the private funds they advise. Although Form PF can be heavily burdensome for large hedge fund and private equity fund managers who may need to file the form quarterly, most registered VC firms only need to make the filing annually, and their costs for the reporting are typically not significant.

In considering the overall cost of registering, firms should note that in the past couple of years, the SEC has had an unusually active rulemaking agenda. Under current Chair Gary Gensler, the SEC has proposed a long list of rules, many of which are slated to be adopted in the coming months. Although some of these rules also would apply to ERAs, RIAs would be subject to significantly more, and the cumulative burden of the new rules may be prohibitive for a smaller firm newly registering. Among other requirements, if the proposed rules are adopted, RIAs would be required to send quarterly statements to fund investors detailing various fees and expenses, obtain fairness opinions prior to closing on adviser-led secondary transactions, adopt cybersecurity policies and procedures, disclose environmental, social and governance (ESG) practices and cybersecurity incidents and risks in their Form ADV, custody all client assets – not just funds or securities – with a qualified custodian, and conduct due diligence on outsourced service providers.

In addition, both RIAs and ERAs would be subject to new rules that, if adopted, would prohibit certain activities with respect to their private funds and place limitations on side letters. Among other things, the prohibited activities rule would prohibit an adviser from charging a fund fees or expenses associated with SEC exams and any compliance expenses incurred by the adviser, including registration expenses.

Should I register?

Given the number of variables that go into deciding whether to register, it can be a complicated decision. There is no one-size-fits-all answer. With that said, prior to the current administration at the SEC, an important aspect that a firm might have considered is the amount of resources – time and money – that registration requires. While compliance with additional requirements was an important consideration, it likely was not a determinative factor. Today, however, firms might consider not just the time and money that would be required to register but also the likelihood that they would be able to comply with all the requirements applicable to a RIA, especially if the proposed rules also are adopted. Dedicating a certain level of resources is one thing; inability to operate a business under the burden of compliance is another. For an established VC firm with ample personnel exploring new opportunities, registration may provide freedom from the 20% basket and flexibility to expand its business. But for a smaller firm with limited resources, would that flexibility be crushed by new restrictions and prohibitions that its own team and compliance program might not be able to handle? The answer here is entirely situational, and we are here to guide firms through the various considerations in answering this difficult question.

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