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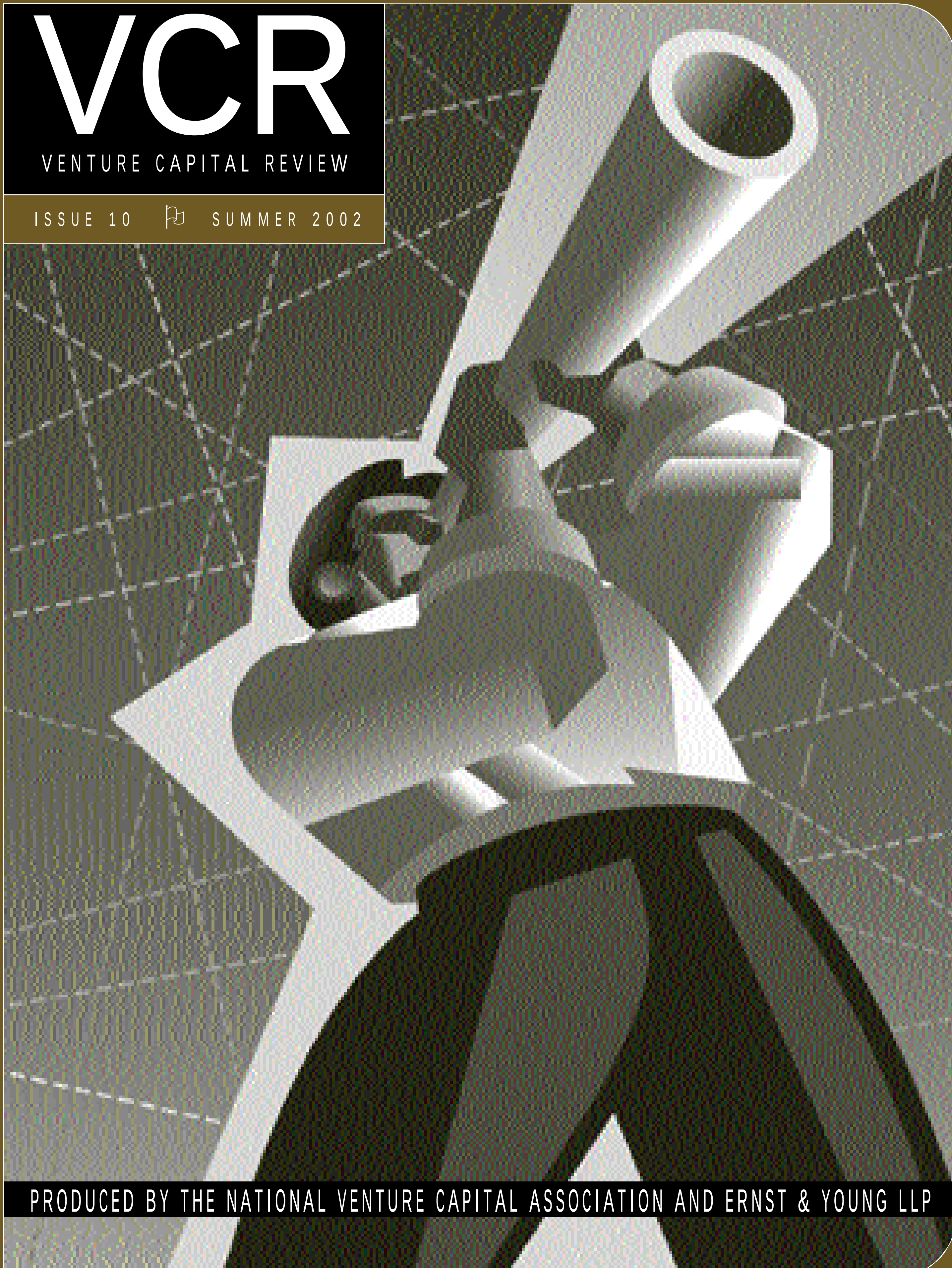
VENTURE CAPITAL REVIEW

ISSUE 10 SUMMER 2002



PRODUCED BY THE NATIONAL VENTURE CAPITAL ASSOCIATION AND ERNST & YOUNG LLP

Investment Adviser Regulation of Private Equity Fund General Partner

BY

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The general partner (the "GP")[1] of a private equity fund (a "PE Fund")[2] constitutes an investment adviser under the Investment Advisers Act of 1940 (the "Advisers Act") and similar state securities laws. Because registration under the Advisers Act and similar state laws generally subjects a PE Fund GP to extensive regulation, a PE Fund GP should seek to take advantage of applicable registration exemptions described below.

If a PE Fund GP is required to register under the Advisers Act, the regulatory burdens to which it is subject include regulation of:

- disclosures to PE Fund investors, including performance numbers,
- transactions between the PE Fund and its GP,
- performance fees (e.g., carried interest) charged to the PE Fund or its investors,
- custody of PE Fund securities, and
- compensation paid to persons who refer investors to the PE Fund.

Proper understanding of the Advisers Act can also assist the GP in structuring its PE Funds so that subsequent growth in the number of such funds, to the point where later Advisers Act registration becomes necessary, will not cause the GP then to be in violation of the Advisers Act.

A. PE Fund GP Constitutes Investment Adviser

A PE Fund GP may not consider itself to be an investment adviser in the common business use of the phrase. However, under the Advisers Act and most state securities laws, an investment adviser is any person (1) who for compensation engages in the business of advising others, (2) as to the value of securities or the advisability of investing in, purchasing or selling securities.[3] Since a PE Fund GP typically receives a management fee and carried interest as compensation for directing the PE Fund's investment decisions regarding portfolio company securities, the SEC, the states and the courts consider the GP to be an investment adviser.

B. Registration Exemption Available to PE Fund GP

Advisers Act and State Registration Requirements. Because a PE Fund GP is an investment adviser, the Advisers Act and state securities laws determine whether registration is required or an exemption from registration is available. A GP required to register must do so under either the Advisers Act or a state statute, depending on the amount of capital commitments in PE Funds managed by the GP. A GP seeking to avoid registration altogether must find an exemption under both the Advisers Act and applicable state laws.

Advisers Act Fewer-than-15-Client Exemption. The Advisers Act exempts a PE Fund GP from registration if the GP (1) has fewer than 15 clients during the preceding 12 months and (2) does not hold itself out generally to the public as an investment adviser. In counting clients to determine whether this exemption is available, the following rules apply:

- Each PE Fund counts as one client so long as the GP manages such PE Fund based on the Fund's investment objective and not based on the limited partners' investment objectives. However, if the PE Fund allows for deal-by-deal investments by the limited partners through opt-ins and/or opt-outs, then each limited partner is generally a separate client.
- If the GP has one or more PE Funds with identical ownership, such PE Funds count as only one client.
- If the GP provides investment advisory services to a PE Fund limited partner (or other person) apart from the PE Fund, such person also counts as a client.
- A natural person, such person's immediate family members and trusts for such persons count as only one client.
- Any PE Fund or other person that does not pay compensation to the GP (e.g., a management fee or carried interest) is *not* counted as a client. Accordingly, a co-invest fund for the GP's employees is not counted as long as the GP receives no management fee, carried interest or other compensation.
- A non-U.S. based GP must count *only* U.S. clients, but a U.S. based GP must count *both* U.S. clients and non-U.S. clients.

Until a GP has formed its 15th PE Fund, it generally is not required to register. If, at the time the GP forms its 15th fund, one or more earlier PE Funds have been out of existence for at least 12 months, such terminated funds no longer count and the 15th fund does not mandate registration.

If a GP forms a PE Fund consisting of several entities — e.g., a § 3(c)(1) 100-or-fewer entity, a § 3(c)(7) QP entity, and a co-invest entity for the GP's employees (which pays compensation to the GP) — all of which entities invest in tandem in each portfolio company (generally pro rata to each such entity's capital commitments), do the multiple entities count as one client or as three clients for the Advisers Act count toward 15? Under any rational application of SEC's integration doctrine, the three entities should be viewed as a single client where they always invest pro rata in the same portfolio companies. However, no SEC pronouncement has yet affirmed this rational view and hence there exists risk that SEC may seek to ignore its own integration doctrine and count each entity separately.

In addition to having fewer than 15 clients during the preceding 12 months, a PE Fund GP seeking to use the fewer-than-15 exemption must not hold itself out generally to the public as an investment adviser.[4] Hence, references in GP marketing materials, websites, advertising or other materials to the GP providing "investment advice," being an "investment adviser" or offering "investment advisory services" should be avoided. Participation by the GP in a private placement of PE Fund's securities is not considered to be a holding out to the public as an investment adviser since such a placement must be conducted without general advertising or solicitation under the 1933 Act.

Alter Ego Issues in Counting to 15. If a PE Fund GP (or its personnel) is affiliated with another entity providing investment advice to clients (e.g., an investment bank), the PE Fund GP may be considered an "alter ego" to the other entity in which case they must aggregate their clients to determine whether the Advisers Act fewer-than-15 exemption is available. In determining whether two or more persons are "alter egos" of each other, SEC looks to the following factors:

- whether there is an adequate buffer between the PE Fund GP and other entity (e.g., a board with a majority of directors not affiliated with the other entity),
- whether the PE Fund GP's investment advisory personnel are engaged in the other entity's investment advisory activities,
- whether the PE Fund GP, in making investment decisions for its PE Funds, uses its own resources and information or shares information and resources with the other entity, and
- whether the PE Fund GP keeps its investment decisions confidential from the other entity until after such decisions have been implemented.

If the PE Fund GP and other entity do not have the separateness required by these factors, the PE Fund GP must count each of the other entity's clients. If the other entity is already registered under the Advisers Act, such as an investment bank, the PE Fund GP obviously cannot use the fewer-than-15 exemption.

Failure to Register Under Advisers Act. For a PE Fund GP with 15 or more clients within the last 12 months which also meets SEC's size requirement (generally at least $25 million of investments under discretionary management as discussed below), failure to register under the Advisers Act can result in SEC administrative sanctions against the GP and its management. In addition, the Advisers Act prevents the GP from enforcing its right to any management fee, performance fee or carried interest as discussed in D below.[5]

Interaction Between Advisers Act Exemption and State Securities Law. For a PE Fund GP exempt from Advisers Act registration (e.g., fewer than 15 clients), state registration may nevertheless be necessary, since almost all states have state investment adviser laws and consider a PE Fund GP to be an investment adviser.

Unfortunately, many states have narrowed available exemptions in recent years. In fact, the model uniform state investment adviser exemption first proposed in 1998 affords no fewer-than-15 or similar exemption from state investment adviser registration for a typical PE Fund GP.

However, some states with significant private fund activity continue to have favorable exemptions from state investment adviser registration for a PE Fund GP based, e.g., on the number of clients or the nature of the clients, including Connecticut, Florida, Georgia (limited to six clients), Illinois, Indiana (limited to six clients), Kentucky, Louisiana, Massachusetts, Minnesota, New Jersey (limited to five clients), New York, North Carolina, Ohio, Oregon, Tennessee, Virginia, Wisconsin and Wyoming (no state regulation of investment advisers).[6]

Many other states impose various requirements which make it difficult for a PE Fund GP to be exempt from state registration. If a GP is located in one of these problem states, state registration issues should be closely examined.

While penalties for failing to register with a state when required to do so vary, they typically include fines, injunctions, and civil damages for management fees, carried interest, attorneys fees, interest and, in some states, any loss suffered by investors (e.g., capital contributions).[7] In addition, in some states failure to register may allow a PE Fund investor to avoid meeting capital commitments.

C. Investment Adviser Registration by PE Fund GP

Division of Responsibility Between SEC and States. SEC is now responsible for registration and oversight of larger advisers (generally at least $25 million of investments under discretionary management) and states are now responsible for regulation and oversight of smaller advisers. In addition, the Advisers Act now preempts state investment adviser regulation for an adviser *registered* under the Advisers Act. Because of this preemption, a PE Fund GP registered with SEC under the Advisers Act need only comply with the Advisers Act and no state exemption from investment adviser registration is required.

If a PE Fund GP has fewer than 15 PE Funds or other clients but is located in a state without a favorable exemption, the GP may register either under the Advisers Act (provided the GP has at least $25 million in investments under discretionary management or meets other SEC registration requirements) or at the state level.

A PE Fund GP would generally prefer to register under the Advisers Act rather than under state law. One significant advantage is the consistency of Advisers Act regulation, including published interpretive guidance for registered advisers on numerous issues and SEC inspection staff experience with a wide variety of investment advisers, including PE Fund GPs. States have few published interpretations, and often have more extensive regulation that could be inconsistent with some PE Fund operations. Also, state examination staff typically lacks the experience and consistency of SEC inspection staff. Finally, for a GP registered under the Advisers Act, partners and others involved in the investment or fundraising process are typically exempt from state licensing and examination requirements for investment advisory representatives, since the GP's clients are typically limited to PE Funds and other institutional clients.[8]

Advisers Act Registration Requirements. To register with SEC under the Advisers Act, a PE Fund GP must:

(1) have at least $25 million in investments under discretionary management, which includes capital commitments, in one or more PE Funds or other client accounts, or
(2) expect to have such amount under management within 120 days after initial registration and actually reach such asset level within the 120 days, or
(3) control, be controlled by, or be under common control with another GP registered under the Advisers Act and have the same principal office and place of business, or

(4) not be located in the U.S. (i.e., a foreign GP).

A PE Fund GP not meeting at least one of these eligibility requirements must register with the state if state law requires registration.

Advisers Act Registration Process. If a PE Fund GP determines that registration is required and meets the eligibility requirements for Advisers Act registration, the initial registration process is accomplished by filing Form ADV with SEC, consisting of two parts. Part I (filed electronically with SEC through a web-based system maintained by the National Association of Securities Dealers) contains basic information concerning the GP, such as:

- types and number of clients,
- types of advisory services provided,
- information about GP personnel, partners, officers and owners,
- whether the GP or its related persons has suffered certain adverse regulatory, criminal, civil or administrative events,
- nature and level of fees charged,
- brokerage practices, including soft dollar use,
- types of transactions, if any, engaged in with clients, and
- whether the adviser has custody of client assets.

Part II, the client disclosure document for investment advisers, is not currently filed with the SEC but must be maintained in GP's records, delivered to clients two days prior to establishing a client relationship and also delivered (or offered) to clients annually (either in the form of Part II or a narrative description of the same information). Part II further describes certain of the information in Part I, such as services, fees, brokerage practices, investment personnel, and transactions with clients.

Once Form ADV is filed with SEC, Advisers Act registration occurs within 45 days unless SEC takes regulatory action to delay registration based on adverse criminal, civil or regulatory background of the PE Fund GP or its personnel. In practice, a GP with no adverse criminal, civil or regulatory matters may be registered in as little as 10-20 days.

D. Advisers Act Restrictions on PE Fund GP

Prohibition on Performance Fees (Including Carried Interest). The Advisers Act generally prevents a registered investment adviser from basing its compensation on the capital gains or appreciation of the client's assets, including a performance fee or carried interest. This restriction would obviously have a devastating effect on the typical PE Fund GP's carried interest in fund profits.

Exceptions to Performance Fees Prohibition. A PE Fund GP may charge a performance fee or carried interest to:

(1) a qualified purchaser fund organized under ICA § 3(c)(7), or
(2) a non-U.S. resident, or
(3) a business development company (not exceeding 20% and based on the BDC's realized capital gains net of realized and unrealized losses), or
(4) a 100-or-fewer PE Fund organized under ICA § 3(c)(1) so long as all PE Fund owners subject to the performance fee or carried interest are "qualified clients," as described below.

For purposes of exception (4) above, a "qualified client" is (i) a person with a net worth of $1.5 million at the time of investment (counting assets jointly owned with a spouse), or (ii) a person with $750,000 under management with the GP (through the PE Fund or otherwise), or (iii) a GP executive officer, director, general partner (or similar person), or (iv) a GP employee whose regular functions or duties involve investment activities for the GP where the employee has at least one year of investment activity experience with the GP or another investment adviser.[9] Where PE Fund is an ICA § 3(c)(1) fund and an entity investor in PE Fund (the "upper tier entity") is itself a § 3(c)(1) fund, a registered investment company or a business development company, the qualified client determination is made not at the upper tier entity level but rather by looking through the upper tier entity and determining if each of its equity owners subject to the performance fee or carried interest is a qualified client.

Only if one of these four exceptions is satisfied may a PE Fund GP which is registered charge a performance fee or carried interest.

Where a PE Fund GP is registered, its Form ADV Part II or client brochure must disclose any performance fee or carried interest and any other information about this type of fee that a PE Fund investor may consider important, such as the fee or carried interest formula and method of valuing assets used in the calculation. Previous Advisers Act specific disclosure that performance fees may result in "riskier" investment strategies was relaxed several years ago, although some disclosure documents continue to include such warning.

Advertising Restrictions. A PE Fund GP which is registered must comply with Advisers Act restrictions on use of misleading advertising. Advertising includes any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, offering any investment advisory services regarding securities. SEC's inspection staff particularly scrutinizes advertising which discusses the GP's prior performance and strictly enforces performance presentation standards outlined by SEC staff in no-action letters.

A PE Fund GP not required to register under the Advisers Act may discuss prior performance, usually an internal rate of return, that is presented *gross* of fees, carried interest and other expenses. However, a PE Fund GP registered under the Advisers Act must generally calculate prior performance *net* of fees, carried interest and other expenses, although a registered adviser is permitted to present *gross* and *net* performance numbers with equal prominence in advertising. For a one-on-one presentation with a sophisticated client, a registered GP may use only *gross* performance numbers if an example is included by footnote showing the compounding effect of fees on performance.

In addition to closely scrutinizing a GP's prior performance results, SEC's inspection staff scrutinizes performance claims of GP personnel achieved at a prior firm to ensure appropriate continuity of personnel claiming such performance and requires adequate records to support the cited performance.

Payment of Cash Solicitation Fees for PE Fund Investors. A PE Fund GP which is registered must comply with Advisers Act restrictions on payment of cash solicitation fees, i.e., generally a portion of the management fee and/or performance fee which the GP pays to a person who solicited investors for PE Fund. The cash solicitation fee rule prohibits a registered GP from paying such a fee unless:

- the solicitor has a clean regulatory history,
- the fee is paid to the solicitor under a written agreement with the GP,
- if the solicitor is a partner, officer, director or employee of the GP (or of an entity controlling, controlled by or under common control with the GP), the arrangement is disclosed to the investor, usually in Form ADV Part II or the brochure, and
- if the solicitor is not affiliated with the GP as described immediately above, the solicitor has agreed in a written agreement with the GP (i) regarding the specific solicitation activities to be performed and the compensation to be paid and received, (ii) to perform all solicitation services consistent with the GP's instructions and the Advisers Act, and (iii) to deliver to the investor at the time of solicitation the GP's Form ADV Part II or brochure and a written disclosure document detailing the arrangements, including the compensation to be paid to the solicitor, and obtain a written acknowledgment from the investor.

Transactions with Clients. Because of concerns over conflicts of interest, the Advisers Act regulates principal and agency securities transactions involving a registered adviser and its client. Prior to selling a security to a client or purchasing a security from a client, a registered adviser is required to obtain informed consent and disclose to the client the material terms of the transaction (e.g., pricing, including the price that could be obtained elsewhere). SEC requires consent to each transaction, and blanket consents are not permissible. Agency transactions involving purchase or sale of securities in client accounts are subject to similar rules if the adviser receives compensation other than advisory fees for the transaction. However, prospective consents for certain agency transactions are permissible.

In a PE Fund context, client consent by an independent committee of fund investors should satisfy the Advisers Act. For a warehoused security (one purchased by the GP in anticipation of forming the PE Fund) sold by a registered GP to the PE Fund shortly after fund closing, disclosure in the offering memorandum (or supplement) and consent in the subscription process should be sufficient.

Custody Rules. The Advisers Act regulates the custody of client funds and securities by a PE Fund's registered GP. A registered GP with actual or constructive custody of client funds and securities is required to follow detailed custody rules, including segregation, recordkeeping and a surprise inspection annually by an independent public accountant.[10] In addition, the adviser must attach an audited balance sheet to its Form ADV Part II or brochure delivered to clients.

SEC considers a registered GP to have constructive custody of securities and funds due to the GP's ability to direct payment of its management fee and carried interest, reimbursement of expenses, and capital withdrawals and distributions. To avoid constructive custody, SEC permits a registered GP to use a third-party custodian (e.g., a bank) for the PE Fund's securities and funds and engage an independent representative (independent accountant or independent attorney) to authorize any payments or distributions to the GP. All capital contributions, portfolio investments and distributions are directed from the PE Fund's custody account and, for payments or distributions to the GP, only after independent representative authorization. The custody arrangements are usually formalized in a letter agreement with the custodian and an agreed upon procedure letter with an independent accounting firm.

GP Change of Control. The Advisers Act makes it unlawful for a PE Fund's registered GP to enter into or perform any advisory contract which does not prohibit assignment of the advisory contract, including a change of control of the adviser, without the client's prior consent. Thus, where a PE Fund's GP is registered, the fund partnership agreement should include specific language prohibiting assignment of the GP interest without client consent.

A transfer of 25% or more of the voting securities in the GP entity may be considered a change of control, although a transaction not resulting in an actual change in GP's control or management is not considered an assignment. Whether a particular transaction is a change of control depends to a significant extent on the GP's structure and ownership.

If a proposed GP transaction may constitute an assignment, appropriate client consent should be obtained prior to closing the transaction because inadvertent change of control of a registered GP without client consent could result in claims that GP's authority and fee arrangements have terminated. The Advisers Act does not specify the percentage consent required from PE Fund's investors, but if permitted by PE Fund's organizational agreements, consent of less than all PE Fund's investors should be adequate.

Trading Restrictions and Reporting. The Advisers Act requires quarterly reporting to the registered GP of securities transactions by the GP's advisory representatives, including partners, officers, directors, investment personnel and employees, control persons and affiliates with access to the GP's investment recommendations. In addition, the Advisers Act requires a registered GP to adopt procedures and policies reasonably designed to prevent insider trading in public company securities by its personnel.

E. SEC Inspection and Oversight of PE Fund Registered GP

Any PE Fund GP registered under the Advisers Act is subject to ongoing SEC inspection. The inspection cycle is at least once every five years, although it is not unusual to be inspected within several years of an initial registration and more often if material deficiencies are discovered.

SEC's inspection staff interview key GP personnel, review the GP's procedures and records and analyze areas of concern in the industry generally (e.g., compliance with new regulatory requirements, such as privacy notices and procedures and anti-money laundering regulation) or as identified in the course of examination. After the examination is concluded, most SEC registered advisers (89% of those inspected in 2001) receive a letter noting one or more deficiencies to be corrected. The adviser is required to respond to SEC within 30 days with proposed remedies.

If SEC discovers material misrepresentations to clients, improper GP actions resulting in client losses or other significant problems, the inspection staff could refer the matter to SEC's enforcement staff for further investigation and proceedings. In 2001, only 4% of all inspections resulted in enforcement referrals. Most deficiencies are resolved amicably between the registered adviser and the inspection staff.

F. PE Fund GP's Planning Issues

A PE Fund GP not registered under the Advisers Act should consider application of the Advisers Act and similar state laws whenever starting a new fund. A PE Fund GP should also periodically review ever changing state registration exemptions even when not forming a new fund. For a GP not registered under the Advisers Act which is forming a new fund, an understanding of Advisers Act requirements may assist in structuring the new fund so a subsequent obligation to register will not cause the GP's existing fund to violate the Advisers Act, e.g., by:

- structuring the performance fee/carried interest so that subsequent GP registration will not cause the prior funds' performance fee/carried interest to violate the Advisers Act,
- structuring GP ownership interests to avoid inadvertent changes of control,
- maintaining underlying documentation to support a performance track record,
- authorizing a consent mechanism for limited partners to approve transactions with conflict concerns (e.g., principal transactions), and
- ensuring solicitation arrangements may be modified upon registration.

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Footnotes

[1] As used in this Article, GP also includes the manager of a PE Fund formed as an LLC.

[2] As used in this Article, PE Fund means an entity (e.g., limited partnership or LLC) intended to be exempt from the definition of "investment company" under § 3(c)(1) or § 3(c)(7) of the Investment Company Act of 1940 (the "ICA"). See Levin, *Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions,* Chapter 10 (Aspen/Panel Publishers 2002).

[3] The Advisers Act excludes from the definition of investment adviser banks, bank holding companies, and certain other persons which give investment advice solely incidental to other services.

[4] An additional requirement of the fewer-than-15 exemption is that the GP not act as investment adviser to an investment company registered under the ICA, such as a mutual fund.

[5] However, the Advisers Act does not grant limited partners a right to additional damages (e.g., losses in value of portfolio securities).

[6] State securities laws are subject to frequent changes. In addition, some of the above listed states may condition their exemption on meeting certain additional requirements, such as confining PE Fund limited partners to designated institutional or accredited investors.

[7] While some states have criminal liability for a willful non-registration, such statutes in practice are rarely enforced except in cases of egregious conduct by an adviser involving e.g., fraud.

[8] States require licensing and examinations (e.g., Series 65) for partners, officers and employees providing investment advice or soliciting clients in the state. For investment advisers federally registered under the Advisers Act, these state licensing and examination requirements *do not apply* if the person does not have more than five natural persons as clients in the state. A PE Fund (and not the PE Fund investors) is considered the client for this purpose.

[9] An administrative, clerical or secretarial employee is specifically excluded as a qualified client.

[10] If the GP is also a registered broker-dealer, these detailed custody rules do not apply because the GP is subject to extensive broker-dealer regulation. SEC has recently proposed changes to the custody rules that would, if adopted, require client funds and securities to be held by a qualified custodian (e.g., a bank) and custodian account statements to be delivered to fund investors unless the fund delivers audited financial statements to fund investors within 90 days of the fund's fiscal year end.

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