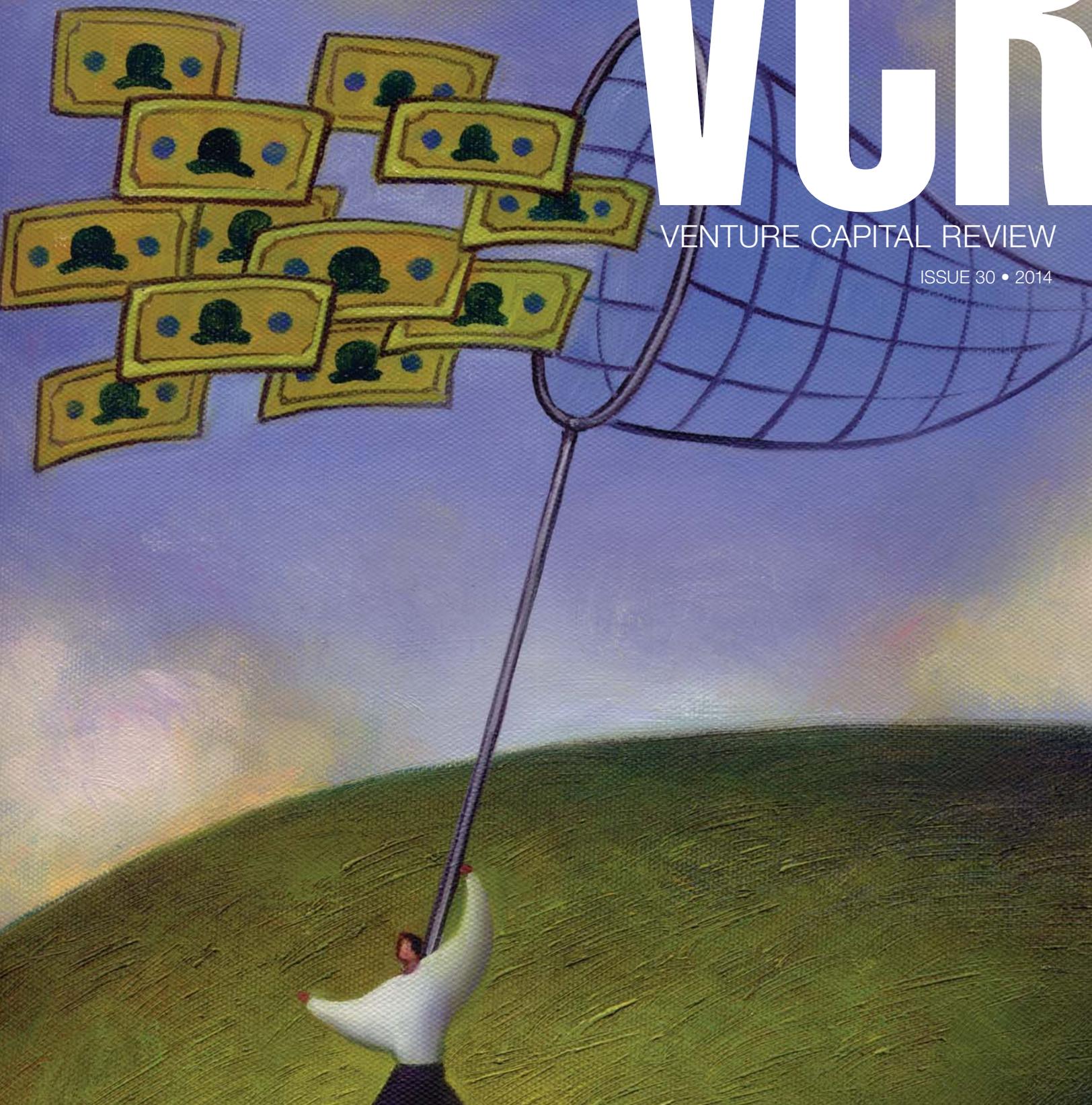


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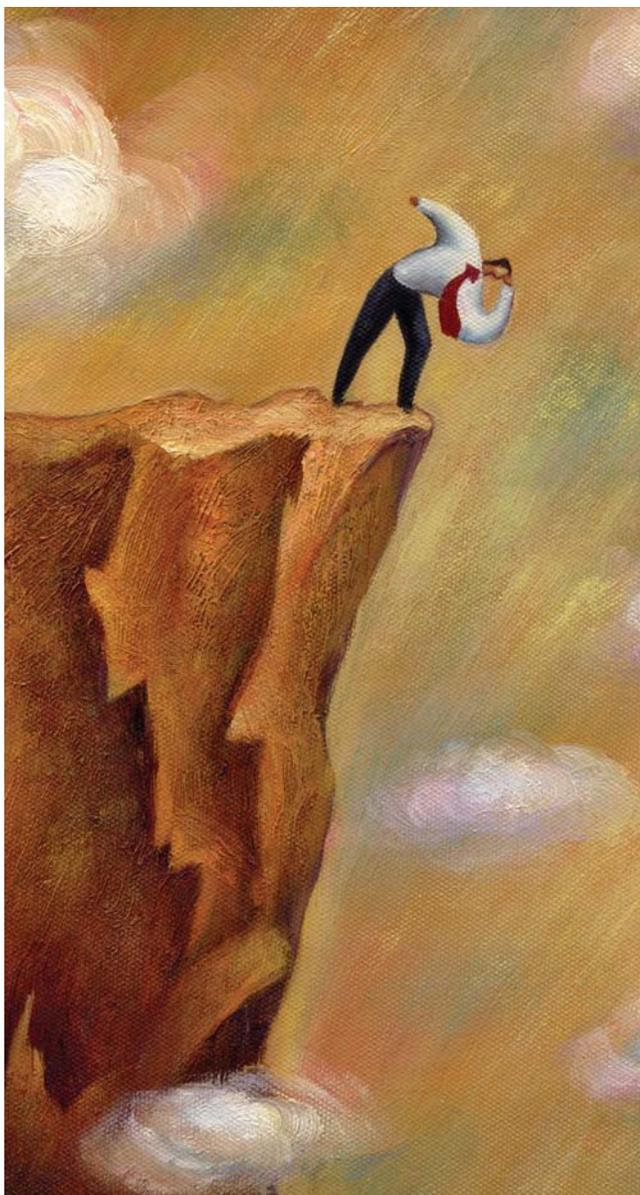
National Venture Capital Association

1655 Fort Myer Drive
Suite 850
Arlington, VA 22209

Phone: 703.524.2549
Fax: 703.524.3940
Web site: www.nvca.org

Don't Get Burned By The "Sunshine": Risk Factors for Venture Capital Firms in an Era of Increasing SEC Scrutiny

Timothy W. Mungovan, Joel Cavanaugh and Michael R. Hackett, Proskauer Rose, LLP



In May 2014, Andrew J. Bowden, the Director of the SEC's Office of Compliance Inspections and Examinations, gave a speech entitled "Spreading Sunshine in Private Equity." While sounding cheery, the "spreading sunshine" metaphor was an ironic evocation of Justice Brandeis's famous statement that "sunlight is said to be the best of disinfectants" in response to social and industrial diseases.

Mr. Bowden used his "sunshine" speech to catalog a number of maladies purportedly afflicting the venture capital industry.¹ According to Mr. Bowden, the SEC identified violations of law or material weaknesses with respect to expenses, disclosure of fees, marketing and valuation practices, and the implementation of effective policies and procedures to ensure compliance. Venture capital firms should view Mr. Bowden's speech as a warning to identify and correct deficiencies *before* a limited partner complains or the SEC commences an examination.

This article addresses a few of the areas that Mr. Bowden identified, including compliance procedures (here we address compliance with the SEC's pay to play rules) and effective disclosures relating to fund expenses. These topics are important for all venture capital firms, including firms that are exempt reporting advisers under the venture capital exemption. The SEC has enforcement authority over these issues, regardless of whether a venture capital firm is registered as an investment adviser.

¹ Although Mr. Bowden referred to the "private equity industry" in his speech, we believe that he used this as a catch-all phrase to include the venture capital industry.

Expense-Shifting and Disclosure

According to Mr. Bowden, the SEC identified violations of law or material weaknesses in controls with respect to expenses in over 50% of the firms reviewed by the SEC during examinations.² Three specific areas of deficiencies were highlighted: (1) the use of consultants, often referred to as “Operating Partners” in private equity and “Venture Partners” in venture capital, without disclosing that the funds or the portfolio companies rather than the management company pay the consultants; (2) the shifting of expenses from management companies to funds during the course of a fund’s life; and (3) automation of certain processes, which advisers use to pass costs from the management company to the funds.

Even though only a handful of cases have been filed to date, the SEC is actively investigating expense-shifting issues in the venture capital and private equity industries. As the Presence Exam Initiative wraps up, firms should expect an increase in SEC activity in this area.

A. Operating/Venture Partners

“Operating Partners” or “Venture Partners” are frequently promoted to potential investors as an integral part of the investment adviser’s team. From a financial point of view, however, the Operating/Venture Partners are treated as independent consultants or advisers who are compensated by the fund or one or more of the fund’s portfolio companies. From the SEC’s perspective, the concern is that the compensation costs are essentially borne by the fund (and indirectly by the limited partners) while the limited partners may believe incorrectly that these Operating/Venture Partners are employees of the management company and compensated out of the management fee. The key question, therefore, is whether the investment adviser has adequately disclosed this compensation structure for Operating/Venture Partners to investors.

In assessing risks, the first step for a venture capital firm is to evaluate whether it has a Venture Partner program that may raise concerns from the SEC’s perspective.

The SEC seems focused on Operating/Venture Partners with some or all of the following characteristics: (1) they receive a draw or some other form of compensation from an investment fund or portfolio company in addition to, or in lieu of, compensation from the management company; (2) they maintain offices at the investment adviser’s offices; (3) they invest in the manager’s funds on similar terms as other employees; (4) they have the title “partner”; (5) they appear on the manager’s website and other marketing materials as full members of the team; and/or (6) they work as part of the investment team and source deals and work on different transactions.

If a Venture Partner program has some or all of these characteristics, the next question is whether the compensation structure was adequately disclosed to the limited partners. Venture capital firms should examine their offering materials, investor letters, financial statements, and audit reports, and, if they are a registered investment adviser, their Form ADV Part 2A disclosure brochures. If the compensation structure was clearly and adequately disclosed to the limited partners, then it is unlikely that there is cause for further concern or action.

If, however, there are doubts about the adequacy of the disclosure, firms should consider whether to make a follow up disclosure of the program to the limited partners. Firms should also consider whether they can or should take other remedial steps, depending on the potential reaction of LPs.

It is difficult to assess precisely how the SEC will handle these cases, particularly where there was some disclosure around the Operating/Venture Partner program and the compensation structure, but perhaps the disclosure was less than perfect. The SEC has filed only one major case clearly relating to an investment adviser’s efforts to shift employee costs to the funds and portfolio companies, *In re Clean Energy Capital, LLC and Scott A. Brittenham*, Investment Advisers Act Release No. 3785 (Feb. 25, 2014). Unfortunately, the case is a poor barometer of the SEC’s approach to Operating/Venture Partners because the conduct at issue in the Clean Energy action was particularly egregious. According to the SEC’s complaint, Clean Energy, which served as an investment adviser to 20 different funds, improperly charged to the funds major expenses such as the salaries of the majority of Clean Energy’s employees, executive bonuses, health benefits,

² It is likely that the “50%” cited by Mr. Bowden is heavily weighted towards private equity firms given that a significant number of venture capital firms are not registered. Nevertheless, we believe that the lessons from the examinations should be heeded by venture capital firms.

retirement benefits and rent, as well as minor expenses like group photos, checks and letterhead, bottled water, office lunches and charges related to transporting the daughter of Clean Energy’s main portfolio manager to and from school.

The SEC assessed whether Clean Energy had disclosed in the offering materials that certain of these expenses would be borne by the fund, and found that the disclosures were inadequate. Most of the offering documents disclosed only that the funds would be required to pay simply “reasonable partnership expenses ‘related to the acquisition or disposition of securities.’” Moreover, several of the funds’ offering materials “expressly state[d] that [Clean Energy] would pay its own management expenses” or that Clean Energy “would pay the compensation of its employees.” In addition, none of these expenses were disclosed in Clean Energy’s Forms ADV or its financial statements.

B. Shifts of Expenses During a Fund’s Life

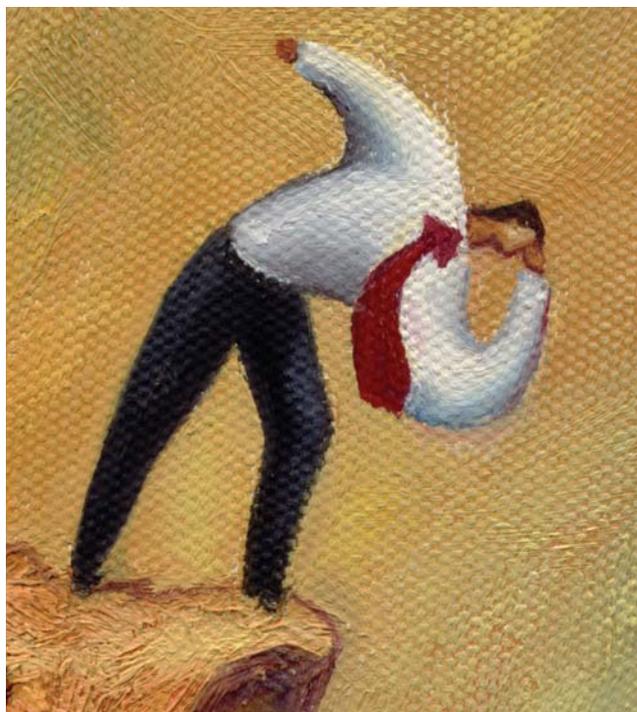
The SEC has initiated a number of actions – even before the conclusion of the SEC’s presence examination program – involving allegations that, during a fund’s life, an adviser had improperly shifted to investors a set of expenses properly charged to the investment adviser. A few examples of these actions include:

In the Matter of Envision Capital Management, Ltd. and Michael M. Druckman

Envision Capital Management was an investment adviser to three funds with extensive holdings in real estate loans, and Michael M. Druckman was its owner and officer.³ As disclosed in each fund’s private offering memorandum, Envision Capital charged monthly fees to the funds. Envision Capital periodically used one fund’s capital to pay the expenses of another fund, without properly disclosing to investors its intent to do so. Envision was charged with disclosure violations. It settled with the SEC, paid a fine, and undertook to review and improve various policies.

In the Matter of Robert Pinkas

An additional SEC action that warrants mention in this article addresses a similar situation, in which certain personnel expenses were shifted improperly to the fund.⁴ In the Pinkas case, Robert Pinkas had been the target of a previous SEC enforcement action and a parallel district court action relating to a “business development” company he managed. While these



actions were pending, Pinkas served as an investment adviser to several private investment funds. Pinkas used assets from one of those funds to cover his legal fees for the prior SEC enforcement action without disclosing this to his investors. Under the fund’s LPA, Pinkas was permitted to use investor funds for legal fees only after he had properly notified investors. Pinkas was alleged to have engaged in misappropriation and misrepresentation of facts in relation to that misappropriation.

The Pinkas case highlights the importance of proper disclosure to investors: the SEC’s enforcement action arose not simply from Pinkas’s attempt to shift fees to investors, but from Pinkas’s failure to properly notify investors of his intent to do so. The Envision action hammers home the same point – the SEC looked closely for evidence that the investment adviser had disclosed its activities to the investor, and found such evidence lacking.

³ *In the Matter of Envision Capital Management, Ltd. and Michael M. Druckman*, Investment Advisers Act Release No. 3160 (Feb. 16, 2011).

⁴ *In the Matter of Robert Pinkas*, Investment Advisers Act Release No. 3371 (Feb. 15, 2012).

Providing investors with disclosures of any fees that the investment adviser plans to charge to the funds will help investors exercise their own oversight over the funds' activities.

C. Process Automation

While the SEC has not yet brought any enforcement actions related to process automation, Mr. Bowden emphasized that the costs of added process automation must fall on the investment adviser, whose responsibilities include generating and delivering proper reports, not on the unsuspecting investor. A good rule of thumb in this regard is to be conscious of whether a certain process that has been automated was one previously handled by the investment adviser: if so, it is likely that it should be charged to the management company, rather than the investors' funds or portfolio companies, unless it has been fully and fairly disclosed.

D. Looking Forward: Improving Disclosures as the Best Defense

Expense shifting is an area of SEC enforcement activity that is still quite new, with very little precedent available to guide funds. One critical trend can be seen across these cases, however: the importance of proper disclosures. In each case, the SEC highlighted the adviser's failure to properly disclose its activities. In light of Mr. Bowden's stated concerns, advisers may also find themselves responding to more requests for additional information from prospective or current investors. Strengthening disclosure protocols to investors should help preemptively aid investors in understanding the fund's financial and cost structure while also limiting an adviser's exposure to a potential SEC's enforcement action.

Going forward, a venture capital firm that wishes to implement, or has already implemented, a Venture Partner program should be sure to provide clear and thorough disclosures on the relationship between the Venture Partners and the investment adviser. These disclosures should, ideally, include information about how the Venture Partner is compensated; what expenses will be paid for by the fund; and what expenses will be paid for by a portfolio company. The venture capital firm should also structure its disclosures

with an eye to the criteria for an Operating Partner mentioned in the "Sunshine" speech. The marketing materials should note any and all distinctions between the venture capital firm's employees and their Venture Partners. This will essentially eliminate the "back door" fee that Mr. Bowden feared, as the investors will be well-informed about the nature of these partners' relationship to the firm as well as the sources of their compensation.

Similarly, proper disclosure of mid-fund-life shifting of expenses, as well as in process automation, also will help obviate Mr. Bowden's concerns about investor information rights. Providing investors with disclosures of any fees that the investment adviser plans to charge to the funds will help investors exercise their own oversight over the funds' activities.

Even though a Venture Partner program may be substantively beneficial to an investment fund, and there may well be a defensible business justification for imposing the costs on the investment fund, the best way to avoid the costs and uncertainty of a dispute with the SEC over the business merits is to make a complete disclosure of the program to the limited partners.

Playing by the Pay to Play Rules

The SEC promulgated Rule 206(4)-5 in 2010 to prevent "pay to play" practices by investment advisers seeking to manage state and local government assets. While the fundamental purpose of the Rule is easy to understand, compliance presents a number of challenges. As a general matter, the Rule provides that if an investment adviser, or a "covered associate" of an investment adviser, makes a contribution to certain elected officials or candidates for office, the adviser is prohibited from receiving compensation for investment advisory services from that government entity within two years of the contribution. In addition, under the Rule, advisers and covered associates cannot "coordinate" or "solicit" contributions to officials of government entities to which the adviser provides (or seeks to provide) investment advisory services.

While the Rule has been in effect for several years, it has only recently gained significant attention from an enforcement perspective, and it now appears to be a high priority for the SEC. In June 2014, the SEC issued its first Order enforcing the Rule, censuring an investment adviser (TL Ventures Inc.) and ordering it to pay nearly \$300,000 for two contributions (totaling \$4,500) by one covered associate. According to its press release announcing the charge, the SEC found that the investment adviser violated the pay to play rules by continuing to receive compensation from two public pension plans within two years after a covered associate made campaign contributions to two political candidates. The SEC found that the political candidates who received the contributions could have had the ability to influence the selection of investment advisers for their state's respective public pension funds. The investment adviser settled with the SEC, resulting in the Order.

Given its limited scope, the Order is probably best viewed as a signal from the SEC that it intends to enforce the Rule vigorously. The takeaway for investment advisers is that they should re-examine their own policies and practices to ensure strict compliance. That does not mean, however, that investment advisers should make only prospective changes to their policies and practices. Instead, investment advisers who are currently managing public money should retrospectively examine their practices and compliance with the Rule – because the SEC certainly will.

The first question that an investment adviser should ask is: who is covered by the Rule, or more particularly, who is a “covered associate?”

The Rule defines a covered associate as:

- (i) Any general partner, managing member or executive officer, or other individual with a similar status or function;
- (ii) Any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and
- (iii) Any political action committee controlled by the investment adviser or by any person described in paragraphs (f)(2)(i) and (f)(2)(ii) of this section.

Section 275.206(4)-5(f)(2).

Stating the definition is easier than applying it, particularly at the margins (i.e., to people who are not “key persons”) where there is most likely room for disagreement and error. In an implicit recognition that the definition may be vague in some circumstances, the SEC tried to give it further meaning in the Order in TL Ventures case, stating that ““covered associates’ are officers and employees of the adviser who have a direct economic stake in the business relationship with the government client.” Putting aside whether that explanation clarifies the definition, it seems to suggest that the SEC is focused on persons who will receive a direct economic benefit from the government entity’s investment in the fund – beyond mere continued employment.

Complicating matters further, the Rule has some retroactive characteristics, meaning that even a “new” covered associate – either by way of a new hire or an internal promotion – may come with baggage. The Rule provides an exception for new covered associates who made a covered contribution more than six (6) months prior to becoming a covered associate – provided that the new covered associate will not be soliciting clients for the adviser. However, if the newly hired or promoted covered associate will be soliciting clients for the adviser, the Rule treats that person’s political contributions the same as existing covered associates, and any covered contributions by that individual – even if made before they were hired or promoted – would trigger the Rule’s two-year “time out” provision as to the adviser.

The first question that an investment adviser should ask is: who is covered by the Rule, or more particularly, who is a “covered associate?”



As a result, investment advisers must not only determine who their covered associates are, they also must evaluate contributions by potential hires, employees being considered for promotion, or anyone else with whom the adviser becomes affiliated if that person may be or may become a “covered associate” under the Rule. Investment advisers would be wise to assume a broad definition of “covered associate” in examining their own personnel – particularly where the personnel may have engaged in political activity. The safest practice, of course, is to consider every person affiliated with the firm who is substantively involved in the firm’s business to be a “covered associate” under the Rule, and to craft the firm’s compliance policies accordingly. Creating ad hoc exceptions for certain firm personnel or persons affiliated with the firm – especially if the reason for doing so is that a certain individual is particularly politically active – will create an additional layer of complexity in dealing with the SEC if the firm’s compliance with the pay to play Rule comes under scrutiny.

Knowing who is a covered associate, however, is only half the battle. Investment advisers must also identify whether a covered associate’s activity constitutes a “contribution” or a “solicitation” under the Rule – and it is not as simple as asking whether someone wrote

a check or made a financial contribution. Broadly, a “contribution” is transferring something of value for a political purpose, whereas a “solicitation” is a communication to arrange a contribution or political payment.

The distinction between these activities is critical, as it affects the potential penalties an adviser faces for a violation. An unlawful contribution triggers the two-year time out on providing investment management services *for compensation*. As in the TL Ventures matter, the SEC may seek disgorgement of an adviser’s fees paid by the government entity for that two-year period (among other penalties). An unlawful solicitation, however, does not trigger the two-year timeout, but may subject the adviser (and the covered associate who solicited a contribution) to civil and criminal penalties.

Even though the distinction between contribution and solicitation is critical, applying the distinction in practice is not straightforward. For example, a contribution concerns a transfer of value, whereas a solicitation concerns mere communication; but a covered associate’s donation of time to solicit contributions (e.g., by organizing political events) may be viewed as a contribution under the Rule if, for example, the adviser

solicited the covered associate's political activities or the covered associate used the adviser's resources, such as telephones and office space, to engage in political activity. The proper classification of a covered associate's activities may turn upon the specific facts presented, and may determine whether the adviser can retain its fees from government clients for the two years following such activities.

Advisers should also note that the Rule is written broadly, and they should assume that it is a strict-liability, prophylactic measure. What advisers or their covered associated *intended* to do is likely irrelevant: unlike Rule 10b-5, the SEC has taken the position that proving a violation of Rule 206(4)-5 does not require a showing of scienter or *quid pro quo*. Additionally, whether the violation was "direct" or "indirect" is irrelevant.

In sum, compliance with the pay to play Rule is complex, and there is a dearth of guidance. In addition, there are various state law analogues that have a different scope. Investment advisers whose personnel engage – or have engaged – in any political activities should develop and enforce policies to ensure strict compliance, and review past practices to correct deficiencies.

Conclusion

The SEC's focus on the venture capital industry is intensifying, particularly with respect to compliance and disclosures. The best way for venture capital firms to avoid unwelcome scrutiny is to adopt robust compliance procedures and adhere to them scrupulously.

About the Authors

Timothy W. Mungovan is a partner in the Litigation Department of Proskauer Rose LLP and co-head of the firm's Private Investment Funds Disputes Group. Tim focuses his practice on representing fund sponsors and institutional investors in avoiding and resolving disputes that are specific to private investment funds. Tim has extensive experience representing fund sponsors and investment advisers with respect to claims of fraud and breach of fiduciary duties. Tim also has substantial experience handling regulatory investigations and defending claims of securities fraud brought by the Department of Justice, the SEC and private plaintiffs.

Joel Cavanaugh is an associate in the Litigation Department of Proskauer Rose LLP and a member of the Private Investment Funds Disputes Group. Joel's practice focuses on disputes involving private investment funds, including venture capital, private equity, and hedge funds. He also has experience in a broad range of complex litigation matters, including intellectual property, mergers and acquisitions, and securities disputes.

Michael R. Hackett is an associate in the Litigation Department of Proskauer Rose LLP and a member of the Private Investment Funds Disputes Group. Mike's practice focuses on disputes involving private investment funds, including venture capital, private equity and hedge funds, and he regularly advises funds and fund sponsors. Mike also represents corporate and individual clients in complex commercial and securities disputes.

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