REGULATORY & COMPLIANCE BRIEFING

Exempt Reporting Advisers

Background

In the aftermath of the Credit Crisis of 2008, Congress focused their attention on reshaping capital markets to provide the type of oversight and transparency that they hoped would help avoid similar crises in the future. The culmination of their efforts was passed as the Dodd-Frank Act. As a result of this legislation, smaller advisers and asset managers, who had previously been excluded from oversight, are now faced with new reporting requirements, among other changes.

Under the act, advisers with less than $100 million in assets are required to register with State regulatory bodies, while those with more than $100 million must now register with the SEC. While some states have modified these standards -- New York advisers with more than $25 million must register with the SEC -- for the most part, the lines defined by Dodd-Frank have remained standard throughout the U.S..

The Act did, however, leave an exception in place for advisers who service venture capital fund investors and advisers to private funds. These two categories of exception are jointly

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referred to as Exempt Reporting Advisers (or ERAs). To qualify for this exemption, a venture capital fund must face restrictions on leverage and investment types, and must represent itself as a venture capital fund (or have done so in the past).

To meet the private fund exemption, an adviser must have less than $150 million in assets under management in the United States. The aggregate total value of all the adviser's private funds must be below this $150 million threshold, and all assets are counted as within the United States (even those held at offices internationally) if the principal office and place of business of the adviser is in the United States. Non-U.S. advisers (whose principal office and place of business is outside the United States) only have to count assets held at U.S. offices towards the $150 million threshold.

Even ERAs are still required to report some information to the SEC, including Item 11 in Part 1 of Form ADV, which covers both civil and criminal disciplinary history. This reporting requirement has allowed Bates to garner insights from previously undisclosed information regarding ERAs. As of November 1, 2013 there were 2,542 ERAs registered with the SEC. A detailed look at ERA filings indicates that 5.27% of ERAs reported some type of regulatory, criminal or civil disciplinary issues. Our independent analysis identified over 130 Exempt Reporting Advisers with at least one disciplinary disclosure against the firm or advisory affiliates.

Regulatory Actions

The most common type of disciplinary activity disclosed was a finding by a federal (excluding SEC and CFTC), state or foreign regulator of a violation of an investment-related regulation, with 59 ERAs (or 45% of those reporting a disciplinary issue) noting this type of disclosure. Similarly, 20 ERAs noted that a Self-Regulatory Organization found the firm in violation of its rules. Disclosures of that type would obviously be highly relevant to investors looking to make asset allocation decisions, since they relate directly to investment practices.

Additionally, 26 firms revealed the SEC or CFTC entered an order against the firm in connection with an investment related activity. 20 ERAs reported that a regulator found the firm or advisory affiliate made a false statement or omission, also of interest to potential investors. Four ERAs report that an SRO disciplined the firm by expelling, suspending or otherwise restricting its activities. Finally, one ERA reported that an SRO found it to have caused an investment-related business to have its authorization to do business denied, suspended or revoked.

Criminal & Civil Actions

Investors may be surprised to learn that 10 firms or affiliates reported felony convictions or guilty pleas. Of the ten firms that disclosed felony convictions or guilty pleas, only two were U.S.-based firms. Thirteen ERAs were found in civil actions to have been involved in violations of investment-related statutes or regulations. Furthermore, there are currently 29 ERAs involved in civil proceedings.

39% of ERAs are based overseas, mostly concentrated in other major financial centers such as the United Kingdom, Hong Kong and Singapore.

Based on our analysis of the disclosure reporting, foreign-based ERAs have reported disclosure items at a higher rate than their U.S.-based counterparts. 9.3% of foreign-based firms reported at least one disclosure item versus only 2.7% of firms with their main office located in the U.S.

Most interesting is the overall divide in firms reporting disciplinary disclosures by claimed ERA type - venture capital fund versus small private fund. Over 70% of ERAs rely solely on the private fund exemption, slightly more than 20% rely solely on the venture fund exemption and the remainder claim more than one exemption. A full 91% of firms that had a disciplinary disclosure had relied on the small private fund exemption to qualify as an ERA. 6.6% of firms relying on the private fund exemption reported a disclosure item versus 1.9% of funds relying on the venture exemption.

About The Bates Group LLC

The Bates Group is a leading provider of securities litigation support, regulatory and compliance consulting, and forensic accounting services. Its growing list of 50 financial industry experts and damages consultants situated in Lake Oswego, Oregon and throughout the United States has provided expert consulting services on a multitude of topics within these practice areas. With more than three decades of experience working with Fortune 500 companies, leading law firms, financial services companies and regulatory bodies worldwide, The Bates Group continues to set industry standards. More information about The Bates Group is available at www.batesgroupllc.com.

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