Updates
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Exempt Reporting Advisers: The SEC Is Watching

On March 12, 2020, the Securities and Exchange Commission (SEC) announced a settlement with Texas-based exempt reporting adviser Naya Ventures, LLC (Naya) and its two founders for failure to disclose several conflicts of interest and failure to take measures required by Naya Ventures Fund I, L.P.'s (Fund) governing documents.[1] Naya agreed to provide a copy of the SEC's settlement to all the Fund's limited partners and pay a penalty of $40,000; the founders were also required to each pay a $20,000 penalty. This serves as a reminder that the SEC is examining exempt reporting advisers, and although not subject to all the provisions of the Investment Advisers Act of 1940 (Advisers Act), exempt reporting advisers have a fiduciary duty to their clients and are subject to the anti-fraud provisions of the Advisers Act.

A copy of the Order can be found here.

Alleged Violations

The SEC alleged the following violations:

- **Failure to Establish an Investor Advisory Committee.** The Fund's limited partnership agreement (LPA) required Naya Ventures Fund 1 GP, LLC (Naya GP), the Fund's general partner and wholly owned subsidiary of Naya, to establish an Investor Advisory Committee (IAC) made up of at least three independent limited partners. The Fund's private placement memorandum (PPM) represented that notice would be provided to the IAC of any transactions involving portfolio companies and Naya, Naya GP, or any affiliates. Contrary to the LPA and the PPM, however, the Fund operated from October 2012 to August 2018 without the required IAC.
- **Failure to Disclose Affiliate Compensation Conflict.** Motivity, an affiliated entity of the founders and a portfolio company of the Fund, entered into contracts with other Fund portfolio companies to provide services for compensation. Naya GP had an obligation under the PPM to notify the IAC about these compensation arrangements, which it did not do because the IAC was not formed until August 2018.
- **Failure to Disclose Defaulting Partner Conflict.** The Fund received $13.5 million in capital commitments from 53 limited-partner investors (including the two founders) and Naya GP, but Naya GP, the founders, and most of the limited partners failed to fully satisfy capital calls. The LPA provided Naya GP with "absolute" discretion to protect the Fund's interests by, among other things, demanding payment of the balance due as an interest-bearing loan or forfeiting the defaulting limited partner's distribution rights. As the SEC noted, Naya GP chose not to enforce any remedies against any of the limited partners who had not contributed fully in response to capital calls, which was a majority of the investors and included the founders. The SEC's Order found that the decision concerning whether to deem the founders in default presented a conflict of interest that required disclosure to the Fund, whether through the IAC or otherwise. The conflict "pitted the Fund's interest in receiving its committed capital against [the co-founders'] interest in avoiding being deemed in default and becoming subject to remedies" such as one or more of those listed in the LPA. The SEC noted Naya did not disclose this conflict of interest to the Fund, either through the IAC, which had not been formed, or otherwise.
- **Failure to Provide Audited Financial Statements.** The LPA required Naya GP to provide the limited partners annual audited financial statements of the Fund. The Fund never engaged an accounting firm to

perform such audits and never provided the audited annual financial statements to limited partners.

As a result of the above actions, the SEC alleged that Naya and the founders violated: (1) Section 206(2) of the Advisers Act, which makes it "unlawful for any investment adviser … directly or indirectly … [t]o engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client" and (2) Section 206(4) of the Advisers Act and Rule 206(4)-8 under the Advisers Act, which make it unlawful for any investment adviser to a pooled investment vehicle to "[m]ake any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle" or "engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle."[2]

Reminders and Takeaways

1. **Exempt Reporting Advisers Are Subject to Disclosure and Conduct Requirements.** Even though they are not registered under the Advisers Act, as advisers to private funds, exempt reporting advisers have a duty to disclose or cause the private fund to disclose material facts, including whenever the adviser is faced with a conflict or a potential conflict of interest.
2. **Exempt Reporting Advisers Should Consider Implementing a Compliance Regime.** Although exempt reporting advisers are not subject to many of the substantive requirements of the Advisers Act, given that they are fiduciaries and can be examined by the SEC, to mitigate risk, they should consider adopting compliance policies and procedures relevant to their operations. Similar to compliance programs for registered advisers, these policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred.[3]
3. **Do as You Say.** It is important for an investment adviser to implement and follow every obligation disclosed in a private fund's offering materials or partnership agreement. If there are any material changes to or deviations from how the adviser operates the private fund, the adviser should promptly update the offering materials and notify investors or seek to amend the partnership agreement.
4. **Cooperation Can Make a Difference.** The SEC often takes into account the adviser's remedial actions, how promptly they are undertaken, and the adviser's cooperation with the SEC staff.

Endnotes

[1] In the Matter of Naya Ventures, LLC et al., Investment Advisers Act Release No. 5461 (March 12, 2020).

[2] Violations of Section 206(2) may rest on a showing of negligence (rather than intent); violations of Section 206(4) and Rule 206(4)-8 do not require proof of intent.

[3] *See* Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Release No. IA-2204 (Feb. 5, 2004) *available at*: https://www.sec.gov/rules/final/ia-2204.htm) (Adopting Release). In the Adopting Release, the SEC stated that "policies and procedures be reasonably designed to prevent violation of the Advisers Act, and thus need only encompass compliance considerations relevant to the operations of the adviser … [and] … [w]e would expect smaller advisory firms without conflicting business interests to require much simpler policies and procedures than larger firms that, for example, have multiple potential conflicts as a result of their other lines of business or their affiliations with other financial service firms." While Rule 206(4)-7 does not enumerate specific elements that must be included in policies and procedures, in the Adopting Release, the SEC noted that, at a minimum, policies and procedures should address the following issues to the extent they are relevant: portfolio management processes; trading practices; proprietary and personal trading; accuracy of disclosures; safeguarding of client assets; recordkeeping; marketing advisory services; valuation; privacy; and

business continuity plans.

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