May 25, 2022

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549

Re: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (File Number S7-03-22)

Dear Ms. Countryman:

PROOF Management, LLC is an exempt reporting adviser advising a family of venture capital funds (collectively, “PROOF”). PROOF agrees with the conclusions of the National Venture Capital Association (“NVCA”) that the proposed rules are flawed, and PROOF respectfully submits that the proposal should be withdrawn for the reasons contained in this letter. In the alternative, the rules should not be applied to those private funds meeting the definition of a venture capital fund or exempt reporting advisers relying on the venture capital fund adviser exemption. As the NVCA explained in their detailed comments, the Commission’s proposal represents a radical departure from Congress’s longstanding determination that private funds (including venture capital funds)—whose investors are required by law and the Commission’s own rules to be the most sophisticated in the world—should not be subject to the type of regulatory requirements that generally apply to retail-level investment companies. As pointed out by the NVCA, the Commission would impose significant additional costs on PROOF and other venture capital fund advisers without any significant benefits.

Introduction

The statutory scheme governing investment advisers makes special recognition of the unique status and role of venture capital in the American economy. Section 202(a)(11) of the Advisers Act defines an “investment adviser” in pertinent part as “any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.” Under the Advisers Act, persons meeting this definition (so-called “registered investment advisers”) must register with the Commission unless an exclusion or exemption applies.

By contrast, Congress has determined that advisers solely advising venture capital funds should be exempt from registering with the Commission. Section 203(l) of the Advisers Act states that an “investment adviser that acts as an investment adviser solely to 1 or more venture capital funds” is not subject to the registration requirement and is therefore referred to as an “exempt reporting adviser”. Although exempt from registering as an investment adviser, exempt reporting advisers must still submit regular reports to the Commission containing information regarding, among other things, basic identification details, form of organization, other business activities, financial
industry affiliations, and basic information regarding the size and organizational, operational, and investment characteristics of each private fund they advise.

Congress created the exemption from registering as an investment adviser in 2010 based on its belief that “venture capital funds... do not present the same risks as the large private funds whose advisers are required to register with the SEC under this title.” Congress reasoned that the activities of venture capital funds “are not interconnected with the global financial system, and they generally rely on equity funding, so that losses that may occur do not ripple throughout world markets but are borne by fund investors alone.”

**Definition of a Venture Capital Fund and the Exempt Reporting Adviser**

The Commission’s was charged with defining a “venture capital fund” which is a subset of the group of private funds. In other words, all private funds are not venture capital funds, but all venture capital funds must be private funds because a venture capital fund must be a private fund that pursues a venture capital strategy. The Commission created a multi-factor test to define whether a private fund is pursuing a venture capital strategy, pursuant to Rule 203(l)-1 of the Investment Advisers Act. For an adviser to utilize the venture capital fund adviser exemption, each fund being advised must satisfy each of the follow factors of the definition:

1. **Representation:** Must represent itself as pursuing a venture capital strategy, including in investor and marketing materials;

2. **Leverage limitations:** Strict limitations on the use of leverage at the portfolio company and fund levels;

3. **Redemptions:** Prohibition on annual redemptions of investors; and

4. **Qualifying investments:** At least 80 percent of a fund’s activity must be direct investments into private companies, or “qualifying” investments.

Violation of any of these parameters by even one fund managed by an exempt reporting adviser can trigger the registration of the adviser and the registered investment adviser regime for every fund managed by that adviser.

**Investors in a Venture Capital Fund**

In addition to the regulatory scheme applicable to exempt reporting advisers advising solely one or more venture capital funds, there are highly selective regulations as to who the investors may be in a private fund—including a venture capital fund—that the exempt reporting adviser is advising. To qualify as a private fund, and thus be eligible to qualify as a venture capital fund, funds managed by PROOF primarily rely on one of the exceptions from the definition of investment company set forth in Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act.
Section 3(c)(1) excepts from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and that is not making and does not at that time propose to make a public offering of such securities.

Section 3(c)(7) excepts from the definition of investment company any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers and that is not making and does not at that time propose to make a public offering of such securities. The term “qualified purchaser” is defined in Section 2(a)(51) of the Investment Company Act.

Regulation D, initially adopted in 1982, contains a safe harbor for determining when an offering is not made or proposed to be made as a public offering. Rule 501 of Regulation D contains a definition of accredited investor that includes the statutory categories of accredited investors plus the additional categories the Commission created. The accredited investor definition outlines types of purchasers that, based on objective criteria indicating financial sophistication and ability to fend for themselves, do not require the protections of registration under the Federal securities laws. For PROOF to ensure it is not making a public offering, and therefore, qualify for the exception to registering a fund as an investment company under the Investment Company Act, all PROOF investors must be, at a minimum, accredited investors within the mean of Rule 501 of Regulation D and most investors are qualified purchasers.

It should be noted however, that even though the offering of securities is by a fund that is excepted from the definition of an investment company, the fund is still subject to the anti-fraud provisions of the Securities Act and the adviser is still subject to the anti-fraud provisions in Section 206 of the Advisers Act.

The Proposed Rules

The Commission has proposed a series of rules imposing new restrictions on investment advisers to private funds, including venture capital funds. As previously outlined, under the Advisers Act, a private fund is “an issuer that would be an investment company” under the Investment Company Act of 1940, “but for section 3(c)(1) or 3(c)(7) of that Act.” Section 3(c)(1) of the Investment Company Act exempts issuers whose securities are owned by no more than 100 persons and Section 3(c)(7) of that act exempts issuers whose securities are owned exclusively by “qualified purchasers,” which are defined to include only the largest, most sophisticated investors. As a result of these provisions, the Commission’s proposed rules will apply primarily to investment advisers to funds that cater to what the Commission and Congress have acknowledged are highly sophisticated investors.

PROOF’s comments are focused specifically on the three proposed rules that present the greatest concern: (1) the prohibited activities rule, (2) the “preferential treatment” rule, which this comment will refer to as the rule regarding side letter rights, and (3) the quarterly reporting rule.
The Prohibited Activities Rule. Proposed Rule 211(h)(2)-1 would bar investment advisers to private funds from engaging in seven kinds of activities. These prohibitions would apply to all investment advisers to private funds, regardless of whether they are registered investment advisers or exempt reporting advisers. In addition, there is no distinction in the rules as to whether these rules apply to private equity funds, hedge funds, or venture capital funds. PROOF objects in particular to the following elements of the proposed rule as the Commission is proposing to apply these rules to advisers utilizing the venture capital fund adviser exemption to the Advisers Act:

a) Liability Limitation Ban. Prohibits seeking reimbursement, indemnification, exculpation, or limitation of liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, recklessness, or negligence in providing services to the private fund.

b) Clawback Reduction Ban. Prohibits reducing the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders.

c) Examination or Investigation Fee Ban. Prohibits charging the private fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority.

d) Regulatory or Compliance Fee Ban. Prohibits charging the private fund for any regulatory or compliance fees or expenses of the adviser or its related persons.

The Side Letter Rights Rule. Proposed Rule 211(h)(2)-3 would bar all investment advisers to private funds from engaging in several practices related to side letters. PROOF objects in particular to the following elements of the proposed rule as the Commission is proposing to apply these rules to advisers utilizing the venture capital fund adviser exemption to the Advisers Act:

a) Side Letter Transparency Ban. Prohibits providing information regarding the portfolio holdings or exposure of the private fund to any investor if the adviser reasonably expects that doing so would have a material, negative effect on other investors.

b) Other Side Letter Rights Ban. Prohibits providing side letter rights to any investor unless the adviser provides advance written notice for prospective investors and annual written notice for current investors.

The Quarterly Reporting Rule. Proposed Rule 211(h)(1)-2 would require registered investment advisers to prepare quarterly statements containing certain information regarding fees, expenses, and performance for any private fund that it advises.

Discussion

Generally. PROOF agrees with the NVCA analysis that the proposed rules would impose costly and complex new requirements on venture capital firms such as PROOF that are entirely
unnecessary, and which would have serious adverse effects on venture capital, those who invest in it, and the companies and ultimately the consumers who benefit so greatly from venture capital funding. The principal problems with the Commission’s proposal are discussed in detail below. For those reasons alone, the proposed rules should be withdrawn, and no final rules should be issued. As an initial matter, however, PROOF agrees with the comments made by the NVCA that it simply is not within the Commission’s authority to issue the proposed rules and to impose their costly mandates. For this reason, the proposal should be withdrawn.

PROOF particularly wants to emphasize that it believes the Proposed Rules are inconsistent with the statutory framework governing venture capital funds and advisers that rely on the venture capital fund adviser exemption.

Taken as a whole, the Commission’s proposed rules represent an attempt to regulate the minutiae of private funds’ interactions with their investors, which would capture venture capital funds and their investors. Congress and the Commission have repeatedly stated that these investors can fend for themselves and do not need the protections of the securities laws.

The Proposed Rules Are Unnecessary, Unjustified, And Would Have Serious Adverse Consequences. None of the Commission’s proposed rules is the product of reasoned decision-making, and all three fail to account for critical aspects of the problem they purport to address. Accordingly, a reviewing court would be required to invalidate the proposed rules as arbitrary and capricious under the Administrative Procedure Act.

The Prohibited Activities Rule Is A Counterproductive Interference With Widely Accepted Contract Terms. The liability limitation ban would have profoundly destabilizing effects on the venture capital industry. The prohibited activities rule—in particular the ban on liability limitations—would have significantly disruptive effects on venture capital fund advisers, including PROOF.

The prohibited activities rule does not allow for “grandfathering” of existing funds, instead allowing only for a “one-year transition period to provide time for advisers to come into
compliance with these new and amended rules if they are adopted.” But many of the elements of the proposed rule require changes to core economic provisions of many existing fund documents. By prohibiting those common features, the proposed rule essentially rewrites fund agreements that have been entered into between sophisticated parties.

Indemnification provisions for simple negligence are standard features of every PROOF fund agreement. These agreements are drafted pursuant to and governed by state law which permits indemnification for simple negligence and has permitted this indemnification for a long time. Copies of PROOF fund agreements are provided to every investor for review prior to the investor making an investment and these investors are sophisticated parties. These investors have the ability to accept or reject these provisions in the form of negotiations or refusing to invest.

Moreover, PROOF relies on the availability of these provisions when obtaining third-party insurance coverage, the cost of which would significantly increase if PROOF were to no longer be able to rely on the indemnification. A change in the standard may make it impossible for PROOF to obtain insurance relating to transactions that may have been completed many years ago. The Commission’s proposed rules threaten to retroactively deprive PROOF of their bargained-for vested rights, changing the risk profile for the adviser without that adviser’s consent and without regard to the very significant consequences of such change.

As pointed out by the NVCA, virtually all venture capital funds, including PROOF, are obligated to indemnify their advisers and their advisers’ employees for simple negligence. Prohibiting indemnification for simple negligence threatens to undo this almost universal industry practice, posing a grave risk to the business model of venture capital funds. This will hurt all participants, including advisers, investors, and the growth companies that venture capital supports. To avoid destabilizing the venture capital industry, the Commission should consider prohibiting limitations of liability only for forms of misconduct surpassing negligence. This alternative would also be more consistent with Congress’s treatment of registered investment companies, which are barred from indemnifying their advisers only for willful misfeasance, bad faith, reckless-ness, or gross negligence—not simple negligence.

The Clawback Reduction Ban Will Upset Reliance Interests and Harm Both Advisers and Investors. As referenced above, a “clawback” generally refers to an adviser’s obligation, under the fund’s governing agreements, to return excess performance-based compensation to the private fund. This performance-based compensation—also known as “carried interest”—is a share of the profits generated by the fund, over and above the adviser’s ownership percentage in the fund. It is a core component of the adviser’s potential compensation in virtually all venture capital funds and operates to further align the adviser’s interests with those of the investors. Because a fund’s expectations of overall profitability can fluctuate over time, the amount of performance-based compensation owed to an adviser can also fluctuate. For example, a fund whose investments perform well in the early stages can trigger contractually agreed-upon distributions from the fund, resulting in a distribution of performance-based compensation to the adviser even though the final profitability of the fund is not yet known. But that fund might later dispose of unsuccessful investments, leading to losses. Clawback provisions require advisers to
return to the fund’s investors excess performance-based compensation that is out of step with the fund’s overall profitability.

This clawback of performance-based compensation raises the question of how to treat tax obligations incurred by the adviser. To use the example posed by the Commission, if an adviser received $10 in excess compensation, on which it paid $3 in taxes, should it pay back $10 (the pre-tax excess) or $7 (the post-tax excess)? Requiring re-payment of the full $10—of which the adviser only retained $7—would mean the performance-based payment has the ultimate effect of turning the adviser’s compensation into a liability. The adviser would be obligated to pay the same amount twice—first to the IRS and then again to the fund’s investors in the form of the clawback. For this basic reason, advisers and investors often agree that the adviser is required to return only the portion of excess distributions that it actually retained after payment of taxes. This is the arm’s-length negotiated term that the Commission now proposes to ban. It is considered acceptable by investors because the investors understand that the adviser really only received $7 of actually benefit from the distribution.

Investment advisers and investors in venture capital funds are well aware of the importance of clawbacks and negotiate their contours in the context of the overall agreement on a fund’s economic terms, including the structure of the adviser’s entitlement to performance-based compensation. However, while it is common practice in the private fund industry to offer clawbacks, there is no requirement for advisers to do so. The incorporation of clawbacks into the terms of most private funds, especially venture capital funds, is the result of freely negotiated agreements between advisers and investors as to the most appropriate balance of risk-sharing and economic alignment.

Many venture capital funds, including the PROOF funds, have so-called “full return of capital” carried interest, whereby performance-based compensation is earned only after investors have received a return of their capital in respect of all of the fund’s investments (not just those that have been realized). The decision as to how carried interest is paid to an adviser is integral to the role a clawback may play in a fund’s overall economic terms. PROOF and its investors settled on a specific approach in the context of trade-offs made on countless other economic terms in fund documents as a whole. For PROOF, the adviser agreed that certain of its employees would personally guarantee any clawback, in exchange for making the clawback post-tax only. As pointed out by the NVCA, the venture capital fund industry has largely settled on the post-tax clawback as the middle ground within the range of possible options. It is this model—the most common form of clawback in highly negotiated venture capital funds with institutional investors—that the Commission proposes forbidding.

By banning post-tax clawback provisions, the Commission upsets the economic arrangement in an arbitrary manner. Indeed, the Commission’s arbitrary prohibition will likely have at least two unintended consequences—neither of which will be in the interest of private fund investors. PROOF, being on its third venture capital fund, is established in the market, with a proven track record and long operating history, would most likely simply refuse to enter into clawback arrangements as a matter of course. Having no clawback protections at all rather than post-tax clawbacks is clearly an inferior outcome for investors in venture capital funds.
The Commission asserts that post-tax clawbacks are unfair because “[a]dvisers typically have control over the methodology used to determine the timing of performance-based compensation distributions.” As pointed out by the NVCA, this is not true. The tax laws as they affect post-tax clawback funds are structured so that advisers have little or no control over the time at which taxable income must be recognized. Without a post-tax clawback provision, some advisers could face bankruptcy. This risk arises in the case of an under-performing fund that has generated only enough performance fees to cover the taxes due—it will not have the liquidity to fund a pre-tax clawback. This is why post-tax clawbacks have become the most common form of clawback in most venture capital funds. PROOF agrees with the NVCA that the Commission has no basis to require advisers to forfeit such a key contractual provision.

PROOF does not agree with the NVCA that the Commission should consider the alternative of using enhanced disclosures instead of banning clawback reduction provisions. Advisers and investors have a range of options for addressing clawbacks, ranging from requiring full clawback to no clawback at all. However, the investors by the admission of Congress and the Commission are sophisticated investors. These investors receive all the fund documentation to which they will be bound upon making their investment and are encouraged to and often do consult outside counsel and financial advisers. These investors, based on their own needs, are by definition capable of understanding the fund documents and the ramifications of each of their provisions on their own situation. Based on the history of an adviser, the amount being invested by the investor, and other considerations, requiring prominent disclosure of the clawback provision, as well as annual reporting of the amount of performance-based compensation that was not clawed back as a result of taxes already paid, is a time consuming and potentially expensive undertaking by the adviser with little or no benefit to the investor. PROOF disagrees with the NVCA that this information would allow the sophisticated investors in venture capital funds to make informed determinations about the costs and benefits of clawback reduction provisions in fund agreements as the enhanced disclosure would provide no useful additional information for making an investment decision in the first place and the disclosure would be conditioned in its entirety by reference to the applicable provision in the fund agreements.

The Bans on Charging Fees to the Private Fund will Hurt Both Advisers and Investors. The prohibited activities rule’s ban on charging regulatory and compliance fees to the fund will also have detrimental effects on investors. The proposed ban may cause two different reactions. On the one hand, certain advisers may respond to the ban by investing less in compliance and other administrative costs. Many investors in venture capital funds agree to pay compliance and regulatory costs in order to incentivize advisers to invest in compliance matters. By removing this option, the proposed rules would limit investor choice and disincentivize compliance to the overall detriment of the fund. Compliance costs go to pay for practices such as having fund financial statements audited to provide investors with assurance about the accuracy of financial reporting and disclosures, or obtaining independent oversight of fund financial reporting by external, independent fund administrators. By discouraging investment in these protective measures, the proposed rule would ultimately harm the interests of investors who benefit from accurate and reliable reporting.
On the other hand, PROOF more likely would offset the ban by simply increasing overall fees. As the Commission recognizes, the prohibited activities rule “would likely require advisers that pass on the types of fees and expenses we propose to prohibit to re-structure their fee and expense model.” That restructuring would impose significant and immediate costs on the fund that would ultimately be borne by investors. And, once advisers are prohibited from passing through certain fees, they may increase their fixed management fees to account for these new expenses, which would result in a deadweight loss for investors.

In addition, as pointed out by the NVCA, the proposed ban on charging fees for examinations or investigations or for regulatory or compliance matters to the venture capital fund would also have harmful effects on the ability of new managers to establish themselves and their funds in the marketplace. Many venture capital funds are much smaller than typical private equity funds; they may have been started by managers from underrepresented backgrounds who lack ready access to start-up capital themselves. Having the ability to charge these expenses to the fund (rather than requiring the management company to bear them) can be critical to managers operating on tight operating budgets. For a Commission that recognizes the need to expand minority and female participation in the financial markets, it is arbitrary and improper to adopt an unnecessary prohibition that will make it more difficult for new managers to compete and succeed.

The Side Letter Rights Rule Will Cause Needless Confusion with No Benefit. PROOF agrees with the NVCA that, like the prohibited activities rule, the side letter rights rule will undermine the Commission’s stated goals.

The side letter rights rule betrays a lack of understanding of the practical realities of venture capital funds and those relying on the venture capital adviser exemption. The proposed side letter rights rule will prohibit advisers from providing information regarding portfolio holdings to any investor if the adviser reasonably expects that doing so would have a detrimental effect on other investors. The Commission attempts to justify this prohibition on the ground that “[s]elective disclosure of portfolio holdings or exposures can result in profits or avoidance of losses among those who were privy to the information beforehand at the expense of investors who did not benefit from such transparency.”

Whatever merit this concern may have in other contexts, it has no merit in the context of a venture capital fund, which by its very definition is not permitted to redeem investors before the end of the life of the fund. Because investors in closed-end funds, such as every fund that meets the definition of a venture capital fund, are unable to redeem their shares before the end of the fund life, an investor that has been granted information rights typically is unable to act on any additional information they obtain vis a vis any other investor in the fund. Yet, the Commission’s proposal nonetheless requires venture capital fund advisers to assess in every instance whether disclosure to certain investors will harm others. While the conclusion for a venture capital fund will always be that the disclosure will not have an adverse effect on other investors, the fact that a venture capital fund must make a determination based on the Commission’s broad and vaguely worded requirement threatens to cause confusion in this process, in addition to imposing significant new recordkeeping and administrative burdens without providing any real investor protection.
In addition, the Commission recognizes that the side letter rights rule will impose additional direct costs on advisers for “updating their processes for entering into agreements with investors, to accommodate what terms could be effectively offered to all investors once the option of preferential terms to certain investors has been removed.” But the Commission fails to acknowledge that those costs are not outweighed by any potential benefit that may accrue to an investor in a venture capital fund such as PROOF.

The Commission acknowledges that side letter rights are rights granted to one or more investors that are not granted to other investors. What the Commission fails to recognize is that in order to be permitted to offer the side letter rights, virtually all venture capital fund agreements contain a provision permitting the adviser to offer different terms to different investors. Again, Congress determined that it could safely leave qualified purchasers and accredited investors to evaluate the merits and risks of an investment for themselves and negotiate on their own behalf when dealing with venture capital funds. If issues related to side letters are important to a prospective investor in a venture capital fund, they certainly can request that information. If an adviser is unwilling to provide the information, these prospective investors are sophisticated enough to evaluate the merits of an investment based on the disclosure they have received without the Commission dictating the disclosure they should receive.

The Quarterly Reporting Rule Will Drive Up Fund Costs and Provide No Additional Benefit. The quarterly reporting rule is unnecessary. As discussed, the vast majority of investors in venture capital funds are accredited investors and qualified purchasers who, by definition, are sophisticated investors. That observation applies with even greater force to venture capital funds, whose investors are among the most sophisticated in the world. It is highly unlikely that such investors are unable to protect their interests without the Commission’s intervention. For decades, the current system has balanced in relative harmony the needs of investors for information with the ability of advisers to provide it. As pointed out by the NVCA, the Commission fails to substantiate any need for a disruption of these longstanding arrangements.

The Commission contends that “[o]paque reporting practices make it difficult for investors to measure and evaluate performance accurately and to make informed investment decisions.” Again, this betrays a lack of understanding by the Commission of the business of a venture capital fund. Quarterly reporting, as it relates to a venture capital fund, occurs only after the investor has invested. As venture capital funds, by definition, are closed-end funds, there are no further investment decisions that are made by the investor. The investor will be an investor in the venture capital fund for the life of the fund as there are no redemption rights.

Even though quarterly reporting as it relates to venture capital funds has no relation to the investment decision of the investor, PROOF recognizes that investors need certain reporting for other reasons. PROOF does provide quarterly reporting, because, as the NVCA points out, the current system has balanced in relative harmony the needs of investors for information with the ability of advisers to provide it. However, creating a rule to requiring quarterly reporting to be harmonized across all private funds upsets this harmony without providing any investor protections.
Conclusion

PROOF understands that private funds can provide systemic risk and that there is the occasional bad actor. However, the one size fits all private funds solution proposed by the Commission is a disservice to the industry.

Venture capital funds and advisers relying on the venture capital fund exemption are unique subset of private funds. Congress recognizes this and the Commission recognizes this. If the Commission does not withdraw the proposed rules altogether, the Commission should consider less restrictive alternatives. As explained in the context of venture capital funds and advisers relying on the venture capital fund exemption, the proposed rules generally provide little to no benefit or protections to investors in venture capital funds and venture capital funds provide little to no systemic risk to the overall financial system. Yet, the recordkeeping and administrative costs associated with these proposals is significant. As an alternative, the Commission should at minimum provide an exception to these proposed rules for venture capital funds and advisers to venture capital funds.

Please feel free to contact me at 571-310-4949 with any questions regarding these comments.

Respectfully submitted,

Michael W. Zarlenga

Michael W. Zarlenga
General Counsel