April 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:

The National Venture Capital Association ("NVCA") appreciates the opportunity to comment on the proposed rules for private fund advisers.

The proposed rules are profoundly flawed and the NVCA respectfully submits that the proposal should be withdrawn. As explained in the detailed comments attached to this letter, the Commission's proposal represents a radical departure from Congress's longstanding determination that private funds (including venture capital funds)—whose investors are among the largest and most sophisticated in the world—should not be subject to the type of granular and often intrusive regulatory requirements that generally apply to retail-level investment companies. The Commission's proposal exceeds the agency's statutory authority and, if adopted, would impose significant costs that greatly surpass any conceivable benefits. The Commission should abandon this misguided proposal and continue to allow the venture capital community to effectively serve and support America's entrepreneurial system.

Please feel free to contact me at [redacted] with any questions regarding these comments.

Respectfully submitted,

Bobby Franklin

President and CEO

Comments of the
National Venture Capital Association

Release Number IA-5955 (File Number S7-03-22)

April 25, 2022

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INTRODUCTION

The Commission's proposal to impose sweeping new restrictions on investment advisers to private funds is fundamentally ill-conceived. Congress purposely determined that private funds should be exempt from the intrusive regulatory regime applicable to registered investment companies, yet the proposed rules would micromanage private funds' interactions with their investors—investors who, by definition, are typically among the largest and most sophisticated in the market. None of the rules the Commission has proposed is supported by evidence of widespread misconduct or need for reform, and each risks harming the very investors the Commission seeks to help. Taken as a whole, the proposed rules threaten grave damage on the venture capital industry.

The Commission's prohibited activities rule, to start, would bar investors and advisers from agreeing to some of the most commonly used private fund terms in the industry. The rule would prohibit the use of indemnification and exculpation provisions covering even simple negligence—even though virtually all venture capital fund agreements contain such provisions. These provisions are critically important to the success of venture capital funds, including their investors and the companies they invest in, in part because venture capital personnel are closely involved in the activities of their portfolio companies. The Commission's ban on indemnification and exculpation provisions would chill advisers' willingness to actively engage in a company's growth, ultimately diminishing fund performance and investor returns.

The Commission's prohibited activities rule would also ban the use of clawback reduction provisions—another common fund term. "Clawback" refers to an adviser's obligation under a private fund agreement to return excess performance-based compensation to the fund. Private fund advisers and investors often agree that clawback of advisers' performance-based compensation should be limited to advisers' post-tax gains. The Commission proposes to take that arm's-length negotiated term off the table, destabilizing existing economic arrangements for countless funds. Moreover, the end result will likely be more funds entering into arrangements with no clawback at all, which would reduce investors' gains.

The prohibited activities rule would also prohibit advisers from charging regulatory and compliance fees to the fund. That restriction would likewise work to investors' detriment by disincentivizing managers from investing in compliance, or by encouraging them to increase fees more broadly to cover the cost. The proposed ban would have a particularly adverse effect on new and emerging managers who often lack ready access to needed resources.

The Commission's side letter rights rule would upset industry norms and sow confusion to no useful end. Side letters allow private funds to accommodate the specific needs or concerns of individual investors. The use of side letters is commonplace among private funds, and the sophisticated investors in those funds closely negotiate over them. The Commission's new requirements regarding the disclosure of side letters and the restrictions on conveying fund information via side letters threaten to create a significant new administrative burden and introduce new confusion for advisers.

Finally, the Commission's proposed rule requiring detailed quarterly statements would needlessly drive up fund costs, with no apparent benefit to closed-end funds, thereby harming both investors and emerging managers.

Put together, these proposed rules would have decidedly negative economic consequences. They would hinder the efficiency of venture capital funds and their portfolio companies by discouraging advisers from taking on significant responsibilities in those companies. The rules would also impair competition—disproportionately burdening new and emerging managers and limiting the options advisers could offer as they compete for investors. And the proposed rules would deter capital formation by increasing the cost for funds, increasing funds' bankruptcy risk, and decreasing the profitability of portfolio companies, all of which would reduce investor returns and push marginal investors out of the capital markets.

In addition to being unwarranted, counterproductive, and economically damaging, the Commission's proposed rules suffer serious legal flaws. The Commission contends that it has authority to adopt the prohibited practices rule and side letter rights rule under a provision of the Advisers Act addressing "sales practices, conflicts of interest, and compensation schemes" that are "contrary to the public interest and the protection of investors."[1] But that provision gives the Commission authority to regulate advisers' sales tactics, not the terms of private funds. The Commission also claims support for the prohibited activities rule and quarterly reporting rule in a provision addressing "fraudulent, deceptive, or manipulative" acts.[2] But the Commission cannot show that common terms like liability limitation provisions and clawback reduction provisions are fraudulent in any way or that the quarterly reporting rule is needed or reasonably calculated to prevent fraud.

Because the Commission's proposed rules would be detrimental to advisers and investors alike, and because the Commission lacks statutory authority to adopt the rules at all, the proposal should be withdrawn in full.

BACKGROUND

A. The National Venture Capital Association

NVCA represents the U.S. venture capital and startup community, advocating for public policies that support America's entrepreneurial system.[3] Venture capital is a uniquely transformative force in our nation's economy. Venture capitalists create partnerships with institutional investors to combine the capital held by pension funds, endowments, foundations, and others with

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[1] 15 U.S.C. § 80b–11(h)(2).

[2] *Id.* § 80b–6(4).

[3] *See* NVCA, *About Us*, https://nvca.org/about-us/ (last visited Apr. 24, 2022).

the talent and expertise of the venture capital fund adviser in order to make high-risk, long-term equity investments in innovative young companies.

Venture capital funds are generally partnerships that last ten to fifteen years, building investments far longer than any other asset class. Unlike most other institutional asset classes, which focus on mature businesses, venture capital funds make equity investments in nascent companies. And far from merely cutting a check, venture capital funds actively strive to develop startups into successful companies—working alongside the entrepreneurs by taking board seats, providing strategic advice and counsel, opening contact networks, and offering broad-spectrum assistance aimed at turning ideas into reality.[4]

With this unique investing model, venture capital supports businesses that could not be financed with traditional bank financing, that pose a disruptive force to the industries in which they operate, and which typically require five to eight years or longer to reach maturity. The results of venture capital investments have been tremendous. Companies that received venture capital funding in their incipient stages include giants like Apple, Microsoft, Amazon, Alphabet, Meta, and Tesla—six of the seven largest U.S. companies by market capitalization.[5] These six companies alone have contributed more than $7 trillion to the U.S. stock market over the last decade.[6] Venture capital also backed companies like Moderna, NeuMoDx, and Zoom that were invaluable during the COVID-19 pandemic, and is currently backing companies such as Aurora Solar, BlocPower, and Apeel Sciences that are working on solutions to the climate crisis.[7]

Venture capital is a major driver of economic growth, spurring job creation, innovation, and new business models that transform the world. In 2021, venture capital funds invested $332

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[4] *See* NVCA, *What is Venture Capital?*, https://nvca.org/about-us/what-is-vc/#toggle-id-1 (last visited Apr. 24, 2022).

[5] Will Gornall & Ilya A. Strebulaev, *The Economic Impact of Venture Capital: Evidence from Public Companies* 2 (June 2021), https://papers.ssrn.com/sol3/papers/cfm?abstract_id=2681841.

[6] *Id.*

[7] *See* Bobby Franklin & Gregory Brown, *Numbers Don't Lie: America's Most Resilient Jobs Are Venture-Backed*, The Hill (Feb. 24, 2022), https://thehill.com/opinion/finance/595509-numbers-dont-lie-americas-most-resilient-jobs-are-venture-backed/; *BlocPower Raises $63 Million Series A to Green Urban Buildings and Creates Innovative Financing Solution Alongside the Goldman Sachs Urban Investment Group*, PR Newswire (Feb. 22, 2021), https://www.prnewswire.com/news-releases/blocpower-raises-63-million-series-a-to-green-urban-buildings-and-creates-innovative-financing-solution-alongside-the-goldman-sachs-urban-investment-group-301232145.html; Steven Mufson, *A Surge in Green Financing Boosts Climate Businesses*, Washington Post (Jan. 27, 2021), https://www.washingtonpost.com/climate-solutions/2021/01/27/surge-green-financing-boosts-climate-businesses/; *Apeel Sciences Announces $250M in New Financing to Improve Resilience of Fresh Food Supply Chain and Fight Global Food Waste*, PR Newswire (May 26, 2020), https://www.prnewswire.com/news-releases/apeel-sciences-announces-250m-in-new-financing-to-improve-resilience-of-fresh-food-supply-chain-and-fight-global-food-waste-301065188 html; Timothy Hay, *NeuMoDx Molecular Raises Series B for Automated Diagnostic Testing*, Wall Street Journal (Apr. 1, 2014), https://www.wsj.com/articles/DJFVW00020140401ea41av3c0.

billion in U.S. businesses.[8] Almost a third of the largest 300 U.S. companies have been backed by venture capital.[9] From 1990 to 2020, employment at venture-backed companies grew 960%, while total private sector employment grew only 40%.[10] Moreover, the economic growth empowered by venture capital is broadly distributed across our economy: 62.5% of venture-backed jobs are outside the states of California, New York, and Massachusetts.[11] In 2021, the median venture capital fund size outside those three states was $28.65 million.[12] In short, venture capital is a key contributor to increased economic opportunity and technological progress for countless Americans.

B. Venture Capital And The Advisers Act

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."[13] 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 most advisers to 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").[14] Congress created this exemption 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

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[8] NVCA 2022 Yearbook 6, https://nvca.org/wp-content/uploads/2022/03/NVCA-2022-Yearbook-Final.pdf.

[9] Gornall & Strebulaev, *supra* note 5, at 11.

[10] Gregory W. Brown et al., *An Analysis of Employment Dynamics at Venture-Backed Companies Between 1990 and 2020*, at 1 (Feb. 2022), https://nvca.org/wp-content/uploads/2022/02/Employment-Dynamics-at-Venture-Backed-Companies_FINAL.pdf.

[11] *Id.*

[12] NVCA 2022 Yearbook, *supra* note 8, at 6.

[13] 15 U.S.C. § 80b–2(a)(11).

[14] *Id.* § 80b–3(*l*). 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. *See* 17 C.F.R. §§ 275.204–4(a), 279.1; Form ADV, SEC, https://www.sec.gov/about/forms/formadv-part1a.pdf (last visited Apr. 24, 2022).

with the SEC under this title."[15] 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."[16]

Nevertheless, despite Congress's judgment that registration was unnecessary for advisers to venture capital funds, NVCA estimates that around 20 to 25% of its members are registered with the Commission—a number that continues to grow. These members are registering because the Commission's definition of "venture capital fund" has not kept pace with market developments.[17] Specifically, many NVCA members advise venture capital funds that acquire shares of companies on the secondary market, often from company founders or angel investors. These secondary share acquisitions place a venture capital fund outside of the Commission's definition of a venture capital fund.[18] As a result, increasing numbers of NVCA members are registered investment advisers.

In addition, all investment advisers, whether required to register or not, are subject to the anti-fraud provisions in section 206 of the Advisers Act.[19] And section 211 authorizes the Commission to promulgate certain rules for investment advisers regardless of their registration status.[20]

C. The Proposed Rules

The Commission has proposed a series of rules imposing new restrictions on investment advisers to private funds.[21] 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."[22] Section 3(c)(1) of the Investment Company Act exempts issuers whose securities are owned by no more than 100 persons.[23] And section 3(c)(7) of that act exempts issuers whose securities are owned exclusively by "qualified purchasers," which are defined to

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[15] S. Rep. No. 111-176, at 74 (2010) (Report from U.S. Senate Committee on Banking, Housing, and Urban Affairs under then-Chairman Chris Dodd (D-CT) explaining the exemption of venture capital funds from the investment adviser registration requirement).

[16] *Id.*

[17] *See* 15 U.S.C. § 80b–3(*l*)(1) (directing the Commission to adopt rule defining "venture capital fund"); 17 C.F.R. § 275.203(*l*)–1 (defining "venture capital fund").

[18] 17 C.F.R. § 275.203(*l*)–1.

[19] *See* 15 U.S.C. § 80b–6.

[20] *See id.* § 80b–11(h)(2).

[21] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16,886 (proposed Mar. 24, 2022).

[22] 15 U.S.C. § 80b–2(a)(29).

[23] *Id.* § 80a–3(c)(1).

include only the largest, most sophisticated investors.[24] As a result of these provisions, the Commission's proposed rules will apply primarily to investment advisers to funds that cater to highly sophisticated investors.

NVCA's comments are focused specifically on the three proposed rules that present the greatest concern to the venture capital community: (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.

1. 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.[25] NVCA objects in particular to the following elements of the proposed rule:

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.

2. 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. NVCA particularly objects to two of the elements of this rule:

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.

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[24] *Id.* §§ 80a–2(a)(51), –3(c)(7).

[25] Private Fund Advisers, 87 Fed. Reg. at 16,920 ("We are proposing this rule under sections 206 and 211 of the Advisers Act, which sections apply to all investment advisers, regardless of SEC-registration status.").

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.

3. 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

I. The Proposed Rules Exceed The Commission's Statutory Authority.

The proposed rules would impose costly and complex new requirements on venture capital firms 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 in Section III below; for those reasons alone, the proposed rules should be withdrawn and no final rules should be issued. As an initial matter, however, 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.

A. The Proposed Rules Are Inconsistent With The Statutory Framework Governing Private Funds.

Taken as a whole, the Commission's proposed rules represent an attempt to regulate the minutiae of private funds' interactions with their investors. That attempt flies in the face of Congress's carefully reticulated statutory scheme.

The securities laws draw a sharp line between registered investment companies and private funds. Regular investment funds—serving ordinary retail investors—are governed by the Investment Company Act, which sets forth detailed rules governing almost every aspect of investment companies' operations.[26] Private funds, on the other hand, are exempt from this intrusive regime.[27] Most investors in private funds are "qualified purchasers"—investors whom Congress presumed to be "in a position to appreciate the risks associated" with their investments and to "evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights."[28] Congress consequently determined that it could safely leave those investors to evaluate the risks for themselves and negotiate on their own behalf when dealing with private funds.

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[26] *See* 15 U.S.C. §§ 80a–1 to –64.

[27] *See id.* § 80a–3(c)(1), (c)(7).

[28] Prohibition of Fraud By Advisers to Certain Pooled Investment Vehicles, Securities Act Release No. 8766, 2006 WL 3814994, at *9 n.45 (Dec. 27, 2006) (internal quotation marks omitted).

The Commission's proposed rules run roughshod over that determination. Rather than allowing these sophisticated investors to reach mutually agreeable arrangements with investment advisers to private funds, the proposed rules take common private fund features off the table and mandate costly new reporting requirements that will serve no useful purpose. By disregarding the statutory framework governing private funds, the Commission's proposed rules go badly astray.

B. The Commission Lacks Authority To Adopt The Prohibited Activities Rule Or The Side Letter Rights Rule.

The Commission asserts that it has authority to promulgate the prohibited activities rule under sections 211(h)(2) and 206 of the Advisers Act.[29] The Commission also appears to invoke section 211(h)(2) as authority for the side letter rights rule.[30] Neither provision supplies any basis for the proposed rules.[31]

1. Section 211(h)(2) Provides No Basis For The Prohibited Activities Rule Or The Side Letter Rights Rule.

Section 211(h)(2) authorizes the Commission to "examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."[32]

That provision cannot support the prohibited activities rule or the side letter rights rule for two reasons. First, those rules do not prohibit or restrict "certain sales practices, conflicts of interest, [or] compensation schemes." And second, the actions prohibited by those rules are not "contrary to the public interest and the protection of investors."

a) The Prohibited Activities Rule And The Side Letter Rights Rule Do Not Regulate "Certain Sales Practices, Conflicts Of Interest, And Compensation Schemes."

Applying traditional tools of statutory interpretation, it is plain that the prohibited activities rule and the side letter rights rule do not regulate "certain sales practices, conflicts of interest, and compensation schemes" within the meaning of section 211(h)(2).

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[29] *See* Private Fund Advisers, 87 Fed. Reg. at 16,920 & n.147 (stating that "we believe that these sales practices, conflicts of interest, and compensation schemes must be prohibited in order to prevent certain activities that could result in fraud and investor harm," and citing sections 206 and 211(h)(2) of the Advisers Act).

[30] *See id.* at 16,928 ("We propose to prohibit these types of preferential treatment because they are sales practices that present a conflict of interest between the adviser and the private fund client that are contrary to the public interest and protection of investors.").

[31] *See* 5 U.S.C. § 706(2)(C).

[32] 15 U.S.C. § 80b–11(h)(2).

The meaning of the term "sales practices" is straightforward. The word "sales" means "operations and activities involved in promoting and selling goods or services."[33] And a "practice" means "the usual way of doing something."[34] Put together, this phrase refers to promotional methods used in making sales of a good or service.

"[T]he specific context in which that language is used, and the broader context of the statute as a whole," serve to flesh out that definition.[35] Here, the relevant context is the provision of investment advisory services. And in that setting, the commonly understood meaning of a "sales practice" is a tactic designed to sway a client to make an investment.

This understanding of the term "sales practices" in the context of investment advisory services is broadly recognized by numerous regulatory actions and judicial opinions. For example, the Commission has described as prohibited "sales practices" "an aggressive cold-calling campaign," "high-pressure sales tactics," "misrepresentations and omissions of material facts," and "baseless price predictions."[36] The Commission has elsewhere characterized as impermissible "sales practices" certain "high pressure sales tactics," "a 'no net selling' policy," and "payment of additional undisclosed compensation to registered representatives in connection with sales" of certain stock.[37] The Commission has also described as a fraudulent "sales practice" recommending and selling investments that were unsuitable in light of the clients' "stated age, financial condition, and stated conservative investment objectives."[38] FINRA, too, treats the term "sales practice" as synonymous with the suitability of an adviser's recommendations to clients.[39] And the D.C.

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[33] Merriam-Webster's Collegiate Dictionary 1097 (11th ed. 2020).

[34] *Id.* at 974.

[35] *Robinson v. Shell Oil Co.*, 519 U.S. 337, 341 (1997).

[36] *A.S. Goldmen & Co.*, Exchange Act Release No. 47,037, 2002 WL 31840963, at *2 (Dec. 19, 2002) (enforcing 15 U.S.C. §§ 77q(a), 78j(b)).

[37] *Hunter Adams*, Exchange Act Release No. 52,662, 2005 WL 2756710, at *1 (Oct. 25, 2005) (enforcing 15 U.S.C. §§ 77q(a), 78j(b)).

[38] *Frederick C. Gartz*, Exchange Act Release No. 37,556, 1996 WL 454822, at *1 (Aug. 12, 1996) (enforcing 15 U.S.C. §§ 77q(a), 78j(b)); *see also* Mary L. Schapiro, *Investor Protection: The Role of the SEC, the SROs, and the Industry in Preventing Sales Practice Abuses* 3–4 (Oct. 9, 1992), https://www.sec.gov/news/speech/1992/100992schapiro.pdf (describing typical "sales practice abuse cases" in which registered representatives make unsuitable and unauthorized investments).

[39] FINRA, Non-Traditional ETFs, Regulatory Notice 09-31, at 1 (June 2009) ("This *Notice* reminds firms of their sales practice obligations in connection with leveraged and inverse ETFs. In particular, recommendations to customers must be suitable . . . .").

Circuit has likewise recognized that unsuitable recommendations are the quintessential example of an abusive "sales practice."[40]

When Congress adopted section 211(h)(2) in the 2010 Dodd-Frank Act, it legislated against this well-known backdrop, with the expectation that the term would continue to carry the same meaning. Thus, the term "sales practice" in section 211(h)(2) is best understood to encompass investment adviser tactics that are designed to influence client investment decisions.

On that understanding, problematic "sales practices" refer to deficiencies in the *manner* in which the product is promoted—such as aggressively pressuring clients to buy the product, lying about characteristics of the product, or recommending a product that the adviser knows is unsuitable for the client. Think of an unscrupulous adviser jawboning a retiree into buying worthless stock.

By the same token, "sales practice" cannot naturally be understood to refer to the *characteristics* of the product itself, apart from the adviser's method of promoting that product. It would make little sense to say that an adviser was engaged in an abusive "sales practice" simply by helping a fully informed client purchase the exact product the client was shopping for, just because that product might have features of which the government does not approve.

This meaning of "sales practices" also informs the interpretation of the next two terms in section 211(h)(2): "conflicts of interest" and "compensation schemes." "Under the familiar interpretive canon *noscitur a sociis*, a word is known by the company it keeps."[41] Consequently, both of these phrases must be interpreted "in light of the terms surrounding [them]"—most importantly, "sales practices" as understood in the context of investment advisory services.[42]

In the setting of promotional sales practices relating to investment advisory services, the phrase "conflicts of interest" is best understood to refer to structural incentives that encourage investment advisers to induce clients to engage in transactions against their best interests. Moreover, the concept of "conflicts of interest" within the meaning of section 211(h)(2) exists only in the context of one party (such as an investment adviser) purporting to act on behalf of another; the conflict arises from a potential agency problem between the adviser and its client, not in arm's-length transactions negotiated between two counterparties plainly acting for themselves.[43]

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[40] *Siegel v. SEC*, 592 F.3d 147, 158 (D.C. Cir. 2010) (self-regulatory organization rule was designed "to protect customers from potentially abusive sales practices by ensuring that a registered representative has reasonable grounds for believing that his recommendation is suitable" (internal quotation marks omitted)).

[41] *McDonnell v. United States*, 579 U.S. 550, 568–69 (2016) (internal quotation marks omitted); *see also* Antonin Scalia & Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts* 195 (2012).

[42] *Leocal v. Ashcroft*, 543 U.S. 1, 9 (2004).

[43] *See* Chester S. Spatt, Chief Economist, SEC, Financial Regulation: Economic Margins and "Unintended Consequences" (Mar. 17, 2006), *available at* 2006 WL 1521997, at *1 (describing "fundamental conflicts of interest and incentives, which economists term 'agency problems' "); Regulation Best Interest: The Broker-Dealer

Likewise, in the context of abusive sales tactics, "compensation schemes" is best read to refer not to any payment arrangement, but to "schemes" in which advisers are compensated in a manner, or through specific practices, that incentivize them to recommend investments that are not in clients' best interest.

The Commission's own past rulemaking bears out these commonsense understandings. For example, the Commission has recognized that conflicts of interest "caus[e] the broker-dealer or its associated persons to make recommendations that place the interest of the broker-dealer or associated persons ahead of the interest of the retail customer."[44] And the Commission has recognized that the quintessential example of a questionable "compensation scheme" is a sales quota or bonus.[45] Such schemes "may create high-pressure situations" by providing an incentive for the associated persons of a broker-dealer "to recommend a specific security over another" and thereby "have a significant effect on an associated person's recommendation."[46] Thus, when understood in context, "conflicts of interest" and "compensation schemes" refer to the structural incentives that may improperly influence broker-dealers and investment advisers as they recommend securities transactions while purporting to act for another—not to the terms of the securities transactions themselves or in the context of an arm's-length transaction between two counterparties acting in their own interests.

Statutory structure supports the same conclusion. Congress enacted section 211(h) as part of section 913 of the Dodd-Frank Act, which is entitled "Study and Rulemaking Regarding Obligations of Brokers, Dealers, and Investment Advisers."[47] In that section, Congress instructed the Commission to "conduct a study to evaluate . . . whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, [and] investment advisers."[48] As part of this effort, Congress adopted section 211(h) under the heading "Other Matters"—showing that the provision's purpose is to close gaps and ensure uniformity in the practices engaged in by broker-dealers and investment advisers, not to regulate the terms of investments (particularly for private funds and their qualified investors).[49]

Standard of Conduct, 84 Fed. Reg. 33,318, 33,403 (July 12, 2019) (describing the "agency cost" that "arises because of the conflicts of interest of the broker-dealer and its associated persons").

[44] *See* Regulation Best Interest, 84 Fed. Reg. at 33,452.

[45] *See id.* at 33,454.

[46] *See id.*

[47] Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1824 (2010).

[48] *Id.*

[49] *See id.* § 913(g)(2), 124 Stat. at 1829; *see also id.* § 913(g)(1), 124 Stat. at 1828 (authorizing the Commission to set "the standard of conduct for [a] broker or dealer . . . [to] be the same as the standard of conduct applicable to an investment adviser").

This reading is borne out by legislative history as well. One of the key drafters of the Dodd-Frank Act, Representative Paul Kanjorski, made clear that the purpose of section 913 was to harmonize the standards of care that applied to broker-dealers and investment advisers.[50] Section 913, he explained, would allow the Commission to "issue new rules establishing that every financial intermediary who provides personalized investment advice to retail customers will have a fiduciary duty to the investor," in order to "fix th[e] long-standing problem" of "investors [being] confused by the legal distinction between broker-dealers and investment advisers."[51] This observation only reinforces what the statute's text, context, structure, and history make plain: Section 211(h)(2) authorizes the Commission to regulate investment advisers' sales tactics, not the terms of the securities they recommend.

The prohibited activities rule and side letter rights rule flout this limitation. The activities banned by the prohibited activities rule have nothing to do with advisers' sales tactics. Rather, they deal with core economic provisions of private funds—most importantly, the availability of liability limitation terms and terms dictating the economic impact of clawback obligations. Section 211(h)(2) does not empower the Commission to sort between acceptable and unacceptable fund terms, and accordingly there is no statutory basis for the prohibited activities rule. In addition, the activities barred by the prohibited activities rule do not implicate any conflicts of interest within the meaning of section 211(h)(2), because they involve arm's-length transactions between self-interested counterparties (investors and private funds), not a structural misalignment between the interests of agents (advisers) and their principals (private funds).

Likewise, the side letter rights rule has nothing to do with advisers' methods of recommending securities transactions. Rather, it prohibits common features of private funds themselves—features that the sophisticated investors in such funds frequently negotiate over. As a gap filling and uniformity provision, section 211(h)(2) provides no basis for the Commission to regulate the terms of private fund investments like these. Congress did not hide the elephantine authority to undo common terms in advisory relationships in the mousehole of section 211(h)(2).[52]

b) The Prohibited Activities Rule And The Side Letter Rights Rule Do Not Prohibit Practices That Are "Contrary To The Public Interest And The Protection Of Investors."

The Commission's proposed prohibited activities rule and side letter rights rule also fail to satisfy the second requirement in section 211(h)(2)—that the prohibited practices be "contrary to the public interest and the protection of investors."

Far from being contrary to the public interest, the practices the prohibited activities rule bans are integral to the success of the venture capital community, which is in turn integral to the

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[50] 156 Cong. Rec. H5237 (daily ed. June 30, 2010).

[51] *Id.*

[52] *See Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 468 (2001) ("Congress, we have held, does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes.").

success of innovative, high-growth companies in the United States. Among private funds, venture capital funds are especially reliant on the availability of indemnification and exculpation provisions. In fact, v*irtually all* venture capital fund agreements indemnify the adviser and its employees for simple negligence.

For venture capital investments to work effectively, venture capital personnel need to be able to take on responsibilities within portfolio companies, including positions as officers and directors. Having firm personnel in those positions improves the chances for success of portfolio companies, enhancing returns for fund investors. But those positions also require the exercise of judgment, often in incredibly difficult circumstances rarely faced by executives of incumbent companies. As a result, this rule will increase firm personnel's exposure to liability even though such actions were taken to maximize the investment potential for the investors in the fund.

Venture capital funds almost universally use liability limitation provisions to protect firm personnel from garden-variety negligence claims, allowing them to step into those positions for the benefit of the fund, portfolio companies, and America's technological advancement and economy as a whole. In the words of the manager of one well-established venture capital firm, these provisions "incentivize well-qualified individuals, including representatives of venture capital investors, to serve actively on company boards of directors, exercising oversight over the companies' affairs and seeking to maximize company value."[53] By banning provisions indemnifying advisers and their employees even for mere negligence, the Commission's proposed rules would destabilize common practice across the entire industry and have a chilling effect on the firm personnel's willingness to become officers and directors of portfolio companies, where they play crucial roles in providing the expertise essential to making the companies successful. The proposed rules would likewise discourage venture capital fund personnel from informally advising portfolio companies without taking a director or officer position—in which situation they would not even have the benefit of the portfolio company's insurance policy for directors and officers.

The Commission's proposed rules would also discourage advisers from taking calculated risks to invest in unproven companies, products, and services that they believe could produce great returns and even change our lives for the better.[54] Without insulation from liability, venture capital fund advisers might never have taken the audacious step of investing in unproven companies like Moderna—which went from being a no-name project in a venture capital incubator program to becoming a world-renowned pioneer in messenger RNA medicines and developer of the lifesaving COVID-19 vaccine.[55] Or they might never have invested in a literal moonshot like SpaceX—which endured years of setbacks and failed launches before becoming the dominant force in U.S.

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[53] Statement by Scott Sandell, Managing General Partner of New Enterprise Associates 1 (Ex. A).

[54] *See id.* at 3.

[55] *See* Jeff Farrah, *Creating the Next Moderna: What VC Offers the World and 3 Public Policy Lessons*, NVCA (Nov. 30, 2020), https://nvca.org/creating-the-next-moderna-what-vc-offers-the-world-and-3-public-policy-lessons/.

rocket flight.[56] The end result of discouraging this kind of risk-taking would be that investors are harmed, not helped.

Indemnification provisions are prevalent in corporate law, including at publicly traded companies. It would be particularly unfortunate if the Commission's proposed rules advantaged incumbent, publicly traded corporations to the detriment of innovative and disruptive private companies.

Every state permits indemnification,[57] as does the federal government for federally chartered corporations.[58] This universal embrace reflects the fact that "[i]ndemnification encourages corporate service by capable individuals by protecting their personal financial resources from depletion by the expenses they incur during an investigation or litigation that results by reason of that service."[59] That key observation applies with even greater force to venture capital funds.

The practices banned by the side letter rights rule are likewise fully consistent with the public interest. Side letter rights are commonplace in private funds, including venture capital funds. Individual investors often request additional contractual terms to address specific needs, concerns, or obligations the investor may have. Because those requests are particularized and do not fit into the broad operating principles for the fund, they are addressed through side letters with the investor. Sometimes those requests pertain to additional information about the fund: A public pension fund, for example, may wish to receive reports in a specific format with specific information, and the adviser may agree to accommodate that request without changing the reporting format and information for all investors. On other occasions, side letters may relate to substantive interests. For example, a larger prospective investor may request a lower performance-based compensation rate on its share of the fund's profits. The adviser may agree to that individual arrangement because securing the large investment will ultimately benefit the fund as a whole. Indeed, offering superior rights to larger investors is a universal principle of private fund management for this very reason. For these reasons, the Commission's proposal is a needless administrative burden that will have operational consequences contrary to the interests of investors and the public.

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[56] *See* Adam Mann, *SpaceX Now Dominates Rocket Flight, Bringing Big Benefits—and Risks—to NASA*, Science (May 20, 2020), https://www.science.org/content/article/spacex-now-dominates-rocket-flight-bringing-big-benefits-and-risks-nasa.

[57] 13 Fletcher Cyclopedia of the Law of Corporations § 6045.10 (2021 ed.) ("All jurisdictions now have statutes authorizing some form of indemnification of directors, officers, agents or other employees.").

[58] 12 C.F.R. § 7.2014.

[59] 3A Fletcher Cyclopedia of the Law of Corporations § 1344.

2. Section 206(4) Likewise Provides No Support For The Prohibited Activities Rule.

The Commission also relies on section 206 as support for the prohibited activities rule.[60] But like section 211(h)(2), section 206 provides no support for the Commission's proposal.

Section 206(4) directs the Commission to "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."[61] To begin with, the Commission has made no attempt to "define . . . [such] practices . . . as are fraudulent." To be sure, the Commission professes its belief that the various prohibited acts "must be prohibited in order to prevent certain [other, unspecified] activities that *could result* in fraud and investor harm."[62] But that is altogether different than defining practices as fraudulent in and of themselves.

Even setting that problem to one side, the Commission would be unable to show that banning the prohibited activities is a means reasonably designed to prevent the never-defined fraudulent acts. Liability limitation terms and clawback reduction terms are common and well-known fund terms that are fully disclosed, and the sophisticated qualified investors in venture capital funds negotiate over such terms at great length. Terms such as these that are freely and openly agreed upon by the parties in arm's-length negotiations are in no way fraudulent, deceptive, or manipulative. Nor has the Commission adduced any evidence that private fund agreements' use of these provisions somehow leads to fraudulent acts.

C. The Commission Lacks Authority To Adopt The Quarterly Reporting Rule.

The Commission apparently relies on section 206(4) as the source of its authority to adopt the quarterly reporting rule, too.[63] But that provision offers no basis for the Commission's proposed rule.

In the Advisers Act, Congress adopted several provisions spelling out in great detail the reporting and disclosure obligations of investment advisers. For example, section 203(c) requires investment advisers to register with the Commission by filing an application containing

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[60] Private Fund Advisers, 87 Fed. Reg. at 16,920.

[61] 15 U.S.C. § 80b–6(4).

[62] Private Fund Advisers, 87 Fed. Reg. at 16,920 (emphasis added).

[63] *Compare* 15 U.S.C. § 80b–6(4) ("The Commission shall . . . by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."), *with* Private Fund Advisers, 87 Fed. Reg. at 16,976 ("As a means reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative, an investment adviser that is registered or required to be registered under section 203 of the Investment Advisers Act of 1940 shall prepare a quarterly statement that complies with [the following requirements.]"). Although the quarterly reporting rule is styled as rule 211(h)(1)–2, the Commission does not discuss section 211(h)(1) as the source of its authority to adopt the rule.

information such as the name of the adviser's organization, the adviser's education, the nature of the adviser's business, a balance sheet, and the basis of the adviser's compensation.[64] Section 204(b) provides specific direction regarding record and reporting requirements for advisers to private funds—those funds that, by definition, have the large and sophisticated investors most capable of protecting their own interests. That section permits the Commission to require an adviser to maintain reports for each private fund it advises describing information such as the amount of assets under management and use of leverage, counterparty credit risk exposure, trading and investment positions, valuation policies and practices of the fund, types of assets held, side arrangements or side letters, trading practices, and such other information as the Commission "in consultation with the [Financial Stability Oversight] Council, determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk . . . based on the type or size of private fund being advised."[65] And section 211(h)(1) directs the Commission to "facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest."[66]

In justifying its proposed quarterly reporting rule, the Commission does not invoke any of these provisions. That is undoubtedly because the proposed rule falls well outside the boundaries of the reporting and disclosure obligations Congress has specifically established. For example, the proposed rule requires private fund advisers to issue detailed quarterly reports disclosing the past performance of funds and the fees that private advisers ultimately received from the funds.[67] That information is far afield from the basic disclosure requirements outlined in section 203(c). The disclosures required by the proposed rule also do not fall into any of the discrete categories in section 204(b)'s framework. The Commission does not even purport to have reached a determination "in consultation with the [Financial Stability Oversight] Council" that the disclosure of such granular information is "necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk."[68] Finally, section 211(h)(1) is facially inapplicable because information like a fund's past performance and the fees ultimately paid by funds to advisers is not a "term" of investors' "relationships with brokers, dealers, [or] investment advisers."[69]

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[64] 15 U.S.C. § 80b–3(c)(1).

[65] *Id.* § 80b–4(b).

[66] *Id.* § 80b–11(h)(1).

[67] *See* Private Fund Advisers, 87 Fed. Reg. at 16,976 (proposing to require disclosure of multiple categories of information, including "all compensation, fees, and other amounts allocated or paid to the investment adviser," "all fees and expenses paid by the private fund," a "table for the private fund's covered portfolio investments," and a wide variety of "performance measures").

[68] 15 U.S.C. § 80b–4(b)(3)(H).

[69] *Id.* § 80b–11(h)(1).

Apparently recognizing that its proposed rules cannot fit into any of the provisions Congress specifically adopted to address reporting and disclosure requirements for advisers to private funds, the Commission attempts to shoehorn this intrusive new regime into the general anti-fraud provision of section 206(4). The proposed quarterly reporting rule transgresses that provision in two ways.

First, the general language in section 206(4) does not allow the Commission to skirt the Adviser Act's specific provisions addressing the reporting and disclosure obligations of advisers to private funds. If the Commission's expansive understanding of section 206(4) were correct, it would render the careful limitations Congress imposed in sections 203(c), 204(b), and 211(h)(1) a nullity. But in statutes—like this one—where "a general authorization and a more limited, specific authorization exist side by side," "[t]he terms of the specific authorization must be complied with" in order to avoid "the superfluity of a specific provision that is swallowed by the general one."[70] That is particularly true where Congress has created a separate provision spelling out specific procedural and substantive requirements that the Commission must satisfy in order to mandate the reporting of additional information not expressly identified in the statute.[71]

Second, section 206(4) requires the Commission to "define" the fraudulent acts it aims to prevent and to "prescribe means reasonably designed to prevent" those acts, but the proposed quarterly reporting rule fails to do either. The closest the proposed rule comes to connecting the new disclosure and reporting requirements to a fraudulent act is the Commission's hopeful statement that the proposed rule "*may* allow an investor to identify when the private fund is incorrectly, or improperly, assessed a fee or expense by the adviser contrary to the adviser's fiduciary duty or the fund's governing agreements or disclosures."[72] But the proposed rule does nothing to show how it would prevent an adviser's deliberate fraud, as opposed to surfacing routine mistakes.

In any event, as the Commission's own explanation makes clear, the primary factor driving the rule is not preventing fraudulent acts but providing more information to investors. The Commission professes its belief that "advisers should provide statements to help an investor better understand the relationship between the fees and expenses the investor bears and the performance the investor receives from the investment because of the opaque nature of the fees and expenses typically associated with private fund investments" and that "periodic statements containing certain required information would allow investors to understand and monitor their private fund investments better."[73] Those aspirations have nothing to do with preventing fraud, so they cannot

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[70] *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639, 645 (2012).

[71] *See* 15 U.S.C. § 80b–4(b)(3)(H) (adviser reports shall contain "such other information as the Commission, in consultation with the [Financial Stability Oversight] Council, determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk, which may include the establishment of different reporting requirements for different classes of fund advisers, based on the type or size of private fund being advised").

[72] Private Fund Advisers, 87 Fed. Reg. at 16,890 (emphasis added).

[73] *Id.*

satisfy the requirements of section 206(4). Moreover, the Commission's conviction that investors in private funds need this kind of hand-holding flies in the face of its recognition that qualified investors are presumptively capable of evaluating "on their own behalf" information like a fund's management fees and the risks associated with investments.[74]

II. The Commission Lacks Authority To Apply The Proposed Rules To Existing Contracts.

The Commission's proposed rules do not allow for "grandfathering" of existing private funds, instead permitting only a "one-year transition period to provide time for advisers to come into compliance with these new and amended rules if they are adopted."[75] As the Commission acknowledges, many of the elements of the proposed rules require changes to core economic provisions of many existing private funds—essentially requiring a do-over of numerous closely negotiated fund agreements. In response to an NVCA survey regarding the effects of the proposed rules, one NVCA member explained that the Commission's proposal would require it to "amend every limited partnership agreement for every fund, review every policy and all our procedures, re-train our staff and essentially—at the risk of sounding dramatic—start our program from scratch."[76] The Advisers Act does not authorize the Commission to engage in retroactive rulemaking of this sort—rulemaking that will "affect vested rights and past transactions."[77]

"The presumption against retroactive legislation is deeply rooted in our jurisprudence, and embodies a legal doctrine centuries older than our Republic."[78] According to that well-settled presumption, courts must "decline[ ] to give retroactive effect to statutes burdening private rights unless Congress has made clear its intent."[79] In the administrative law context, "a statutory grant of legislative rulemaking authority will not, as a general matter, be understood to encompass the power to promulgate retroactive rules unless that power is conveyed by Congress in express terms."[80] And even under circumstances where "some substantial justification for retroactive

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[74] Prohibition of Fraud By Advisers to Certain Pooled Investment Vehicles, 2006 WL 3814994, at *9 n.45 (internal quotation marks omitted).

[75] Private Fund Advisers, 87 Fed. Reg. at 16,933.

[76] On April 1, 2022, NVCA conducted a survey of its members regarding the effects of the private fund advisers proposal.

[77] *Landgraf v. USI Film Prods.*, 511 U.S. 244, 268–69 & n.23 (1994) (internal quotation marks omitted); *see also id.* at 280 (law has "retroactive effect" if "it would impair rights a party possessed when he acted, increase a party's liability for past conduct, or impose new duties with respect to transactions already completed").

[78] *Id.* at 265.

[79] *Id.* at 270.

[80] *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (1988).

rulemaking is presented, courts should be reluctant to find such authority absent an express statutory grant."[81]

The Commission has not identified any express statutory grant of authority to adopt the proposed rules on a retroactive basis—nor could it. The statutory authorities it invokes to support the proposed rules—sections 211(h)(2) and 206—"contain no express authorization of retroactive rulemaking."[82] Section 211(h)(2) simply directs the Commission to "promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes."[83] That provision says nothing about upsetting the reliance interests of advisers and investors who have already entered into fund agreements on the basis of existing Commission rules. And section 206, the general anti-fraud provision, merely directs the Commission to "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."[84] Far from granting express authorization to engage in retroactive rulemaking, that provision specifically requires the Commission to "define" fraudulent acts before promulgating rules to prevent those acts—reflecting our legal system's traditional concern that "individuals should have an opportunity to know what the law is and to confirm their conduct accordingly."[85]

Because the statutes upon which the Commission relies to promulgate the proposed rules contain no express grant of retroactive rulemaking authority, the Commission cannot lawfully apply the proposed rules to existing fund agreements.

III. The Proposed Rules Are Unnecessary, Unjustified, And Would Have Serious Adverse Consequences.

None of the Commission's proposed rules is the product of reasoned decisionmaking, 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.[86]

In addition to the individual problems with the proposed rules detailed below, the Commission has deprived the public of a meaningful opportunity to comment on any of the proposed rules. The APA requires agencies to provide the public with a meaningful opportunity to comment

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[81] *Id.* at 208–09.

[82] *Id.* at 204.

[83] 15 U.S.C. § 80b–11(h)(2).

[84] *Id.* § 80b–6(4).

[85] *Landgraf v. USI Film Prods.*, 511 U.S. 244, 265 (1994).

[86] *See* 5 U.S.C. § 706(2)(A); *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

on a proposed rule.[87] "[T]he opportunity for interested parties to participate in a meaningful way in the discussion and final formulation of rules" is a "particularly important component" of the notice-and-comment rulemaking process.[88]

The Commission has failed to observe that requirement here. The proposed private fund adviser rules are both highly complex (as evidenced by the 92-page NPRM) and highly consequential. Yet the Commission allowed only a 30-day comment window for the public to digest, analyze, and comment on these momentous changes. The D.C. Circuit has noted that, when "substantial rule changes are proposed, a 30-day comment period is generally *the shortest* time period sufficient for interested persons to meaningfully review a proposed rule and provide informed comment."[89] Here, the complexity of the rules at issue prevent the public from "comment[ing] meaningfully within this brief time."[90]

To allow the public a meaningful opportunity to offer informed commentary on the proposed rules, the Commission should—at a minimum—extend the comment period for an additional 60 days.

A. The Prohibited Activities Rule Is A Counterproductive Interference With Widely Accepted Contract Terms.

1. The liability limitation ban would have profoundly destabilizing effects on the venture capital industry. "When an agency changes course . . . it must be cognizant that longstanding policies may have engendered serious reliance interests that must be taken into account."[91] The prohibited activities rule—in particular the ban on liability limitations—would have significantly disruptive effects on venture capital investment advisers.

As previously noted, 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."[92] But many of the elements of the proposed rule require changes to core economic provisions of many existing fund plans. By prohibiting those common features, the proposed rule essentially rewrites plan

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[87] *Rural Cellular Ass'n v. FCC*, 588 F.3d 1095, 1101 (D.C. Cir. 2009); *Conn. Light & Power Co. v. Nuclear Regul. Comm'n*, 673 F.2d 525, 528, 530 (D.C. Cir. 1982).

[88] *Conn. Light & Power Co.*, 673 F.2d at 528.

[89] *Nat'l Lifeline Ass'n v. FCC*, 921 F.3d 1102, 1117 (D.C. Cir. 2019) (emphasis added).

[90] *Id.*

[91] *Dep't of Homeland Sec. v. Regents of the Univ. of Cal.*, 140 S. Ct. 1891, 1913 (2020) (internal quotation marks omitted); *see also FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 514 (2009) (when an agency's "prior policy has engendered serious reliance interests that must be taken into account," "a more detailed justification" is required "than what would suffice for a new policy created on a blank slate").

[92] Private Fund Advisers, 87 Fed. Reg. at 16,933; *see supra* at 18–19.

agreements that have typically been entered into between sophisticated parties represented by counsel.

Indemnification and exculpation provisions for mere negligence are standard features of private fund agreements.[93] These provisions are carefully negotiated between typically sophisticated parties. Moreover, investment advisers rely on the availability of these provisions when choosing to enter into the fund agreement and when obtaining third-party insurance coverage. Such provisions often provide for indemnification or exculpation relating to transactions that may have been completed many years ago. Investment advisers may even be in the midst of lawsuits in which they are relying on negotiated indemnification and exculpation provisions. The Commission's proposed rules threaten to retroactively deprive them 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.

In addition to upsetting investment advisers' reliance interests, the ban on liability limitation provisions actually risks harming the investors it is intended to protect—an "important aspect of the problem" that the Commission has "entirely failed to consider."[94]

Venture capital funds have a particular interest in maintaining the availability of limitation of liability provisions in fund agreements. Unlike with other private funds, firm personnel in venture capital funds are often involved in the activities of their portfolio companies—including as officers and directors—which requires a high degree of judgment. Acting in that capacity for the benefit of both the fund and its portfolio companies exposes firm personnel and the venture capital fund to additional claims and liability. Consequently, for venture capital funds to operate effectively, parties must remain free to negotiate how to limit that liability exposure in a way that ensures that venture capital personnel are willing to take on those responsibilities for the benefit of the fund, including its investors.

Without robust indemnification provisions, many venture capital personnel might be unwilling to serve as officers or directors of portfolio companies, which would diminish one of the key benefits of venture capital and ironically hurt the very investors that the rule purports to serve. As one member put it in response to NVCA's survey, "competent and experienced individuals will be unwilling to engage in the responsible management and advising of private funds if they have no indemnification protection from litigation, personal liability, and the costs of potential claims associated with doing their job."

Indemnification provisions thus play a critical role in facilitating the hands-on approach required by venture capital investments. If the Commission adopts the ban on limitations of liability, venture capital firms will either have to limit the degree to which firm personnel are involved in the activities of their portfolio companies, or acquire more insurance to cover the gap (or cause the portfolio companies to do so)—all to the detriment of the fund's investors.

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[93] *See* Private Fund Advisers, 87 Fed. Reg. at 16,925 ("Currently, many private funds and/or their investors enter into documents containing such contractual terms.").

[94] *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

These concerns are borne out by NVCA's member survey. In that survey, over 42% of respondents said that the Commission's ban on liability limitation provisions would make them less likely to invest in innovative, unproven ideas due to the risk of potential litigation. Over 43% said that the ban would make them less likely to seek voting board seats on the boards of portfolio companies. And over 83% said that the ban would cause an increase in their insurance expenses. One NVCA member summarized the effect on its insurance expenses this way: "Costs are already almost prohibitive and will likely double."

An agency is also obligated to "examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made."[95] That connection is missing here. The Commission justifies the proposed prohibited activities rule on the ground that these activities "could result in fraud and investor harm" by "incentiviz[ing] advisers to place their interests ahead of their clients' (and, by extension, their investors')," ultimately resulting in investors "bearing an unfair proportion of fees and expenses."[96] But banning liability limitation provisions will likely result in diminished returns (if greater risk-aversion leads venture capital funds to limit their role with portfolio companies), increased costs (if funds obtain third-party insurance to cover their liability), or both. Thus, the ban on liability limitation provisions is unlikely to meet the Commission's stated aim of protecting investors' interests or reducing their fees and expenses.

The Commission is also required to evaluate all "significant and viable alternatives" to its proposed rules.[97] Yet in the proposed prohibited activities rule, the Commission devotes only perfunctory attention to the possibility of less restrictive alternatives to its bans on common core features of private fund plans. With respect to the ban on indemnification and exculpation provisions, the Commission should consider the alternative of limiting the ban to provisions based on liability for willful misfeasance, bad faith, recklessness, or gross negligence. As discussed, virtually all venture capital funds indemnify their advisers and their advisers' employees for garden-variety 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 that rely on the close cooperation of adviser employees with portfolio companies. 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, recklessness, or gross negligence—not simple negligence.[98]

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[95] *Id.* (internal quotation marks omitted).

[96] Private Fund Advisers, 87 Fed. Reg. at 16,920.

[97] *Shieldalloy Metallurgical Corp. v. Nuclear Regul. Comm'n*, 624 F.3d 489, 493 (D.C. Cir. 2010) (internal quotation marks omitted).

[98] *See* 15 U.S.C. § 80a–17(i).

The Commission also gives inadequate attention to the alternative of enhanced disclosures. The Commission purports to have considered this possibility, and sensibly acknowledges that "[t]his alternative may be desirable to the extent that certain investors would be willing to bear the costs of these activities in exchange for certain other beneficial terms, and would be willing to give informed consent to fund advisers engaging in the practices under consideration."[99] But the Commission nevertheless rejects this possibility, asserting it is unlikely "that disclosure requirements would achieve the same benefit of protecting investors from harm, because many of the practices are deceptive and result in obscured payments, and so may be used to defraud investors even if detailed disclosures are made."[100] That crucial assumption lacks any factual support, particularly given that the majority of investors in private funds are sophisticated qualified purchasers who are typically counseled and are fully capable of determining the risks and benefits of private fund agreements for themselves.

2. 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.[101] 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 the investors'.[102]

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

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[99] Private Fund Advisers, 87 Fed. Reg. at 16,959.

[100] *Id.*

[101] *See supra* at 1.

[102] In a typical arrangement, a related person of the adviser serves as the general partner of the private fund, and the fund pays performance-based compensation to this related person rather than the adviser itself. For the sake of simplicity, this comment refers to performance-based compensation payments being made to the adviser.

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.

Investment advisers and investors in private 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 is the result of freely negotiated agreements between advisers and investors as to the most appropriate balance of risk-sharing and economic alignment.

By way of example, certain funds have so-called "deal-by-deal" carried interest. Under this approach, performance-based compensation is calculated and distributed on an investment-by-investment basis as individual investments are realized. Other funds, including many venture capital 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.

As the variety of carried interest calculations demonstrates, private fund investors (and their counsel) recognize that a range of approaches exists, and they and the adviser settle on a specific approach in the context of trade-offs made on countless other terms in the negotiation as a whole. For example, investors may agree to a post-tax clawback provision in exchange for a "full return of capital" distribution provision that gives investors extra protection. Or, an adviser may have been willing to agree that its employees would personally guarantee any clawback, in exchange for making the clawback post-tax only. 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 these intricate arrangements 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. First, for venture capital funds that are established in the market, with a proven track record and long operating history, their advisers may 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 private funds. Second, for venture capital funds sponsored by emerging and first-time managers that may not have the ability to negotiate clawback obligations out of their fund agreements, the result will likely be advisers exercising extreme caution in making distributions from the fund, out of fear of potentially triggering a clawback liability that could be economically ruinous for the advisers' employees. This will have a chilling effect on distributions and result in investors having to wait longer to receive their capital than they would in the absence of the Commission's misguided rule. That delay, in turn, would impair investors' ability to promptly redeploy their capital into other investments, and would reduce the value to them of what they ultimately receive (due to the time value of money).

The Commission should not upset completed negotiations by retroactively removing some of those options—particularly when the banned option is the most widely used choice in the industry and will often be better for investors than the alternative should these rules go into effect. A retroactive change in such a fundamental fund term will lead to restatements of (or at least future one-time adjustments to) financial statements and tax returns. Advisers have relied on these provisions in negotiating with investors, and in many cases have relied on them when operating the fund for much of the last decade. The Commission's economic analysis alludes to the need to "re-negotiate, re-structure, and/or revise certain existing deals or existing economic arrangements in response to this prohibition," but fails to quantify the considerable costs of doing so or to compare those costs to the (at best) marginal benefits of the ban on clawback reductions.[103]

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."[104] But that 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 highly negotiated venture capital funds with institutional investors. The Commission has no basis to require advisers to forfeit such a key contractual provision.

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. So long as all parties involved are fully informed, they should be permitted to reach the arrangement that is most suitable to them in the context of the agreement as a whole. The Commission therefore should consider requiring prominent disclosure of any clawback provision in a fund agreement, as well as annual reporting of the amount of performance-based compensation that was not clawed back as a result of taxes already paid. This information would allow the sophisticated investors in private funds to make informed determinations about the costs and benefits of clawback reduction provisions in fund agreements.

3. 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

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[103] Private Fund Advisers, 87 Fed. Reg. at 16,950.

[104] *Id.* at 16,924.

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, certain more established advisers may compensate for 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."[105] 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.

The proposed ban on charging fees for examinations or investigations or for regulatory or compliance matters to the 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.[106] 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 example, if a key initial investor (known as an "anchor investor") helps establish an adviser or takes an interest in an adviser as part of a "seed" deal, the investor may choose to bear some of the adviser's registration and compliance fees as part of the deal's overall economic arrangements. Banning the charging of those fees to the fund will adversely affect the small and first-time managers who depend on seed investments and who may have higher than average registration and compliance costs. As a result, this prohibition will make it more difficult for underrepresented and emerging managers to break into and succeed in the venture capital business. For a Commission that recognizes the need to expand minority and female participation in the financial markets,[107] it is arbitrary and improper to adopt an unnecessary prohibition that will make it more difficult for new managers to compete and succeed.

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[105] Private Fund Advisers, 87 Fed. Reg. at 16,922 n.157.

[106] *See*, *e.g.*, Waverly Deutsch, *Women and Minority Investors Are Taking Matters into Their Own Hands*, Chicago Booth Review (May 10, 2021), https://www.chicagobooth.edu/review/women-and-minority-investors-are-taking-matters-their-own-hands (describing recent increase in new venture capital funds led by women and minority managers); Office of the Advocate for Small Business Capital Formation, Annual Report for Fiscal Year 2021, at 48–53 (2021) (discussing challenges minority-owned businesses face in accessing capital and minority representation in venture capital); *see also* Statement by Gayatri Sarkar, Founder of Advaita Capital 1 (Ex. B).

[107] *See*, *e.g.*, Caroline A. Crenshaw, Comm'r, SEC, Remarks at the Meeting of the Small Business Capital Formation Advisory Committee (Jan. 29, 2021), https://www.sec.gov/news/public-statement/crenshaw-remarks-sbcfac-

B. The Side Letter Rights Rule Will Sow Needless Confusion.

Like the prohibited activities rule, the side letter rights rule will undermine the Commission's stated goals.

1. The side letter rights rule betrays a lack of understanding of the practical realities of private funds. The proposed side letter rights rule would 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."[108]

Whatever merit this concern may have in other contexts, it has none at all in the context of "closed-end funds," in which investors cannot redeem their shares before the end of the life of the fund. Because investors in closed-end funds (including venture capital funds) are unable to redeem their shares before the end of the fund life, they typically are unable to act on any additional information they obtain. Yet, the Commission's proposal nonetheless requires venture fund advisers to assess in every instance whether disclosure to certain investors will harm others. As discussed, venture capital funds frequently grant investors enhanced information rights via the side letter process, often for anodyne reasons such as satisfying individual investors' reporting specifications. The Commission's broad and vaguely worded requirement threatens to sow confusion in this process, in addition to imposing a significant new administrative burden and expense.

2. The additional administrative burdens imposed by the side letter rights rule will weigh particularly heavily on emerging managers. 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."[109] But the Commission fails to acknowledge that those costs would fall particularly heavily on emerging and first-time managers, who are less likely to have the resources needed to bear the additional costs and administrative burdens.

Emerging managers are also more likely to be reliant on recruiting anchor investors, which then allow the manager to raise subsequent commitments. In that scenario, a side letter may be necessary to secure the anchor investment into the fund. Reflecting that concern, in NVCA's member survey, over 71% said that the side letter rights rule would make it more difficult for underrepresented and emerging managers to raise first-time funds. One NVCA member related that "[i]t is extremely difficult to raise first time funds and doing so successfully requires a very

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meeting-012921; Allison Herren Lee, Comm'r, SEC, Remarks to the Small Business Capital Formation Advisory Committee (Aug. 4, 2020), https://www.sec.gov/news/public-statement/lee-remarks-sbcfac-meeting-080420.

[108] Private Fund Advisers, 87 Fed. Reg. at 16,929.

[109] *Id.* at 16,951; *see also id.* at 16,952 ("Disclosures of such preferential treatment would impose direct costs on advisers to update their contracting and disclosure practices to bring them into compliance with the new requirements, including by incurring costs for legal services.").

delicate, thoughtful dance with [investors]. Securing anchor [investor] checks may require special accommodations that simply can't be given to other [investors] or communicated broadly." The Commission's rules thus raise the barriers to entry in the entire industry with long-term adverse effects on capital formation.

3. The Commission has failed to give adequate consideration to reasonable, less restrictive alternatives. Given the closed-end nature of venture capital funds, side letter transparency rights can pose no risk to other investors' interests. Accordingly, while the Commission should drop this proposed requirement altogether, it should at minimum provide an exception for venture capital and other closed-end private funds.

C. The Quarterly Reporting Rule Will Drive Up Fund Costs And Harm Emerging Managers.

1. The quarterly reporting rule is unnecessary. As discussed, the vast majority of investors in private funds are qualified purchasers who, by definition, are large, 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 large 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. 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."[110] But in support of that point, the Commission cites only two letters, neither one of which discusses the unique considerations pertaining to venture capital funds.[111]

2. The quarterly reporting rule will harm investors and small funds by increasing costs. At the same time as the quarterly reporting rule augurs no useful benefits for venture capital fund investors, it promises to materially harm those investors by driving up fund costs to comply with the Commission's onerous new reporting requirements. Moreover, as with the Commission's other rules, these additional costs will fall particularly heavily on small and emerging managers, forcing them to expend resources on complying with the new reporting requirements rather than developing their businesses.

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[110] Private Fund Advisers, 87 Fed. Reg. at 16,892.

[111] Letter from State Treasurers and Comptrollers to Mary Jo White, Chair, SEC (July 21, 2015), https://comptroller nyc.gov/wp-content/uploads/documents/SEC_SignOnPDF.pdf; Letter from Americans for Financial Reform Education Fund to Gary Gensler, Chair, SEC (July 6, 2021), https://ourfinancialsecurity.org/wp-content/uploads/2021/07/Letter-to-SEC-re_-Private-Equity-7.6.21.pdf.

IV. The Proposed Rules Fail To Comply With The Commission's Statutory Obligation To Promote Efficiency, Competition, And Capital Formation.

When the Commission engages in rulemaking in the public interest under the Advisers Act, it has an obligation to consider, "in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[112] Unless the Commission "apprise[s] itself—and hence the public and the Congress—of the economic consequences of a proposed regulation," the "promulgation of the rule [is] arbitrary and capricious and not in accordance with law."[113]

The Commission has failed to satisfy that statutory requirement here. First, the Commission "could not accurately assess any potential increase or decrease" in efficiency, competition, or capital formation because it failed to "make any finding on the existing level" of efficiency, competition, and capital formation in the marketplace.[114] For example, the Commission acknowledges that it has limited insight into the "extent to which advisers *currently* provide [the] information that would be required to be provided under the proposed rule to investors."[115] Without such insight into current practices, the Commission cannot reliably assess any potential increase or decrease in efficiency, competition, or capital formation from the proposed rules.[116]

The Commission has also failed to reasonably attempt to quantify the estimated costs and benefits of the proposal. With respect to the quarterly reporting rule, the Commission acknowledges that "it is generally difficult to quantify [the rule's] economic effects with meaningful precision."[117] Regarding the prohibited activities and side letter rights rules, the Commission similarly recognizes that "several factors make the quantification of many of these economic effects of the proposed amendments and rules difficult," that it is "difficult to quantify how costly it would be to comply with the prohibitions," and that "it is difficult to quantify the benefits of these prohibitions."[118] But it is the Commission's obligation to "make [the] tough choices" in selecting among competing estimates.[119] The Commission cannot just throw up its hands and fail even to "hazard a guess" in attempting to quantify the economic impacts of the proposal.[120]

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[112] 15 U.S.C. § 80b–2(c); *see also id.* § 78c(f) (similar under Exchange Act); *id.* § 78w(a)(2) (same); *id.* § 80a–2(c) (similar under Investment Company Act).

[113] *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (internal quotation marks omitted).

[114] *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 178 (D.C. Cir. 2010).

[115] Private Fund Advisers, 87 Fed. Reg. at 16,944 (emphasis added).

[116] *See Am. Equity*, 613 F.3d at 178.

[117] Private Fund Advisers, 87 Fed. Reg. at 16,944.

[118] *Id.* at 16,948.

[119] *Bus. Roundtable*, 647 F.3d at 1150 (internal quotation marks omitted).

[120] *Id.* (internal quotation marks omitted).

In any event, as the foregoing discussion makes clear, the proposed rules as a whole will have decidedly negative economic consequences.

To start, the proposed rules are not efficient. Indemnification and exculpation provisions are of critical importance to the success of venture capital funds, including their investors and the companies they invest in. Venture capital personnel are frequently involved in the activities of their portfolio companies. And by abolishing indemnification and exculpation provisions, the proposed rules will likely force venture capital funds to limit their personnel's involvement in portfolio companies, hindering the efficiency and success of venture capital funds and their portfolio companies. At the very least, the proposal will require venture capital funds or require their portfolio companies to acquire more insurance—either way, the result would be increased costs borne by investors and a reduction in the funds' profitability and investors' returns.

The proposed rules would also impair competition. As detailed above, the proposed rules would disproportionately burden new and emerging managers, which would limit entry into the venture capital market and hinder competition. At the same time, the proposed rules would eliminate many common fund structures. By taking these and other provisions off the table, the proposed rules would limit the options advisers could offer as they compete for investors and could require terms that ultimately are less advantageous to investors.

Finally, the proposed rules would deter capital formation. The proposed rules would increase the costs for funds—costs that would be borne by investors; create (in the case of the clawback provision) increased bankruptcy risk for funds;[121] deter the entrepreneurialism at the heart of venture capital; and decrease the efficiency of portfolio companies. All of this would reduce investor returns and push investors on the margin out of the venture capital markets.

In NVCA's member survey, over 69% reported that the Commission's proposed rules would increase their compliance or other operational costs—with 55% of those respondents answering that the proposed rules would increase costs "considerably," and over 12% answering that the proposed rules would increase costs "drastically." All in all, the Commission's proposed rules would impede the ability of venture capital funds to nurture the innovative companies of tomorrow, to the overall detriment of the American economy, curbing the availability of venture capital funds and the great good they do for countless American businesses.

CONCLUSION

For the foregoing reasons, NVCA respectfully urges the Commission to withdraw the proposed rules for private fund advisers.

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[121] *See supra* at 25.

Exhibit A

Statement by Scott Sandell, Managing General Partner of New Enterprise Associates

New Enterprise Associates, Inc. ("NEA") is a global venture capital firm focused on helping entrepreneurs build transformational businesses across multiple stages, sectors, and geographies. With nearly $29 billion in cumulative committed capital since the firm's founding in 1977, NEA invests in technology and healthcare companies at all stages in a company's lifecycle, from seed stage through IPO. The firm's long track record of successful investing includes more than 230 portfolio company IPOs and more than 390 mergers and acquisitions.

For NEA, the indemnification and exculpation provisions that are typically included in venture capital limited partnership agreements are a key component of risk management for our firm, our investment partnerships, and our investment professionals. These provisions specifically serve to backstop the analogous provisions contained in portfolio company charters and bylaws, and they are of critical importance when a portfolio company does not have adequate funds or sufficient, available insurance to cover potential defense costs and liabilities for its officers and directors. The risks of incurring such expenses and liabilities are inherent in serving as a corporate officer or director, and even more so in connection with inherently risky venture capital investments. Today, there is scarcely an IPO, an M&A exit, or a significant private financing that does not draw immediate litigation, whether merited or not. As such, these provisions serve to ensure that the liability protections that are routinely included in our portfolio companies' corporate documents can in fact be relied upon. In so doing, these provisions serve exactly the same purpose as the analogous company provisions: to incentivize well-qualified individuals, including representatives of venture capital investors, to serve actively on company boards of directors, exercising oversight over the companies' affairs and seeking to maximize company value. As such, we view these provisions as value-enhancing for our portfolio companies, and for our investment funds.

NEA has encountered more than one situation in which just this sort of "backup" protection has proven essential, particularly in addressing adverse company developments that were unforeseen, and in funding the defense of baseless claims.

In one instance, a portfolio company in the healthcare space encountered a material reduction in its revenue stream when the reimbursement rules for its particular industry were changed in an unexpected way. The company ultimately filed for bankruptcy reorganization; a trustee in bankruptcy sued the directors on behalf of the estate for alleged breach of fiduciary duty; and the company's D&O insurance company took the position that the claim was not covered under the company's substantial insurance policy. Until that coverage dispute was resolved (which required a dispositive motion in the trial court, as well as briefing and argument before the state supreme court), the defendants—including the venture capital representatives who had been directors—were incurring significant defense costs which the estate would not pay. The existence of indemnification from the relevant investment funds proved critical to staying current with those defense costs through the prosecution of a motion to dismiss the lawsuit, and resolution of the insurance coverage dispute. Ultimately, the insurance company accepted coverage; it settled the surviving portion of the lawsuit; and the relevant investment funds were made whole for the defense costs they had meanwhile advanced.

In another instance, NEA stepped in to recapitalize a company that had nearly failed, in order to retain key employees and hire new management, develop a new business plan, and provide financing for further development of its technology. Then, a co-founder of the company, who had been removed as an officer years before, filed suit, claiming that the recapitalization had unfairly diluted the value of his equity. The NEA partner who led the investment as an outside third party did not owe the company or its co-founder any fiduciary duties before the recap closed. The suit was filed anyway. But for the same reasons, the NEA partner also was not covered under the company's D&O policy for any actions he took *before* the transaction closed and he became a director. For actions undertaken *after* that time, including a further company financing, the company's D&O policy stepped forward to provide protection. The existence of indemnification from the relevant investment funds was essential to fund the NEA partner's defense for actions he took during the time that he acted to identify and structure the new fund investment (as to which, the co-founder's claims were held to be meritless). The investment was ultimately exited at a significant multiple of its acquisition cost.

Other examples could be provided. The key point is that the typical indemnification and exculpation clauses included in venture capital limited partnership agreements for advisers and their employees are not extraordinary, but *typical*, and they do not create or enhance any "moral hazard" risks. They merely provide protection from run-of-the-mill director liability risks on terms comparable to those that corporations typically provide and, in so doing, they exist and operate to ensure that directors are protected from liability risks *in the usual way*—including for baseless claims before they even became company directors, and *even if* the portfolio companies they serve cannot fulfill the standard obligations that they have assumed in taking on such directors in the first place.[1]

Although perhaps implicit in the foregoing comments, NEA believes it is important to state explicitly that this type of protection is of critical structural importance to the venture capital business model and its success in financing next-generation companies and technologies. By definition, venture capital funds invest risk capital in a broad swath of early-stage companies and accept service on their boards of directors, in hopes of developing tomorrow's leading enterprises. But in doing so, they also know that despite their due diligence, many of these companies will fail and be incapable of providing adequate director indemnification or insurance protection. Such business failures may be due to a myriad of developments that are inherently unpredictable, such as the emergence of a competing company with a service model or product design that proves more successful in the market, or a more effective novel therapeutic agent, or the successful entry by an established industry player with substantially greater resources into a portfolio company's product or service niche, and so on.

But it is precisely when such companies fail that directors face a potential "Catch-22" of enhanced litigation risk combined with the absence of standard director protection, and it is the

[1] NEA's view of the importance of these provisions is also informed by the D&O liability crisis of the mid-1980's, when the Delaware courts broke with prevailing expectations by exposing corporate directors to risk of personal liability for claims that were not based on conflicts of interest or alleged bad faith conduct, but the level of care they exercised in performing their duties as directors. At that time, the market for D&O liability insurance was nearly paralyzed and it became difficult to find qualified individuals to fill board seats, particularly in early-stage companies, until the Delaware legislature stepped in with a solution that allowed companies to shield their directors from this risk.

"backup" of fund indemnification that solves that problem. Without such protection, the entrepreneurialism that is at the heart of the venture capital industry would be placed at direct and immediate risk, because venture capital investors would be incentivized to curtail the risk-taking that is inherent in their broad-based, early-stage investment strategy in an effort to shield themselves from unbounded personal liability. Instead, venture capital investors would be incentivized to focus on a more limited number of more mature investment opportunities, and that would leave the early-stage entrepreneurs that they have supported for nearly fifty years at a loss to find quality professional financing and business advice. NEA believes that such an outcome would be a significant social and economic loss, precisely because entrepreneurs who cannot access experienced, principled capital will have limited prospects of success, and because the inherent difficulty of identifying tomorrow's leading companies *ex ante* will leave many promising companies unfunded.

NEA respectfully submits that the Commission should not adopt rules that prohibit the protection of venture capital firms and their personnel from liability on the same terms that are almost uniformly provided to corporate directors generally. The venture capital industry should at least operate on a playing field that is level with that of corporate America generally. If anything, such protection is needed more urgently in the venture capital ecosystem, where enterprising entrepreneurs and those who finance them take on outsize risks to innovate and grow our technologies, our business models, and our economy on a scale that conventional industry simply cannot do.

Scott Sandell

Managing General Partner

New Enterprise Associates

Exhibit B

Statement by Gayatri Sarkar, Founder of Advaita Capital

I am a woman-POC fund manager and an immigrant. I am the founder of Advaita Capital, an ESG-Intelligence venture capital fund focused on investing in mainstream tech companies. We are a 100% women-of-color-owned fund. Our team comes from Goldman Sachs, Oppenheimer, the Federal Reserve Bank, and large venture capital funds with strong, proven track records. We invest in post-seed and growth-stage tech startups globally.

Emerging venture capital managers need to make minimum GP commitments of around 2%+ in their first funds, and many underrepresented managers are not from wealthy backgrounds. The SEC's proposed restrictions on the use of side letters will create a barrier to entry for newer funds to raise LP money from the market.

The other proposals made by the SEC—like the liability limitation ban, examination and investigation fee ban, and regulatory and compliance fee ban—will add a lot of operational budgetary stress on new funds, which are mostly on shoe-string budgets. Compliance and regulation make up most of our fund expenses besides fund administrative costs. Moreover, venture capital funds have different strategies than private equity funds. Venture capital funds are mostly passive investors compared to private equity funds and should not be subjected to the same regulations.

Women and underrepresented talents make up a large and growing number of emerging venture capital fund managers, and many of them are solo GPs. Just like startups, they tend to have very few full-time staff on board as well as very few resources. GPs spend a lot of time helping portfolio companies at an early stage as well as a growth stage. If emerging fund managers' tight resources are spent on regulation and legal fees, portfolio companies may not receive the necessary help and support. This will inhibit growth in the ecosystem. Emerging fund managers are also key to venture capital market returns, as they have been outperforming established venture capital funds and hedge funds. The SEC's proposals of new regulations and legal costs may keep underrepresented and POC managers from starting their own venture capital funds.

Gayatri Sarkar

Founder

Advaita Capital