andreessen. horowitz

June 15, 2022

BY ELECTRONIC SUBMISSION

Ms. Vanessa A. Countryman
Secretary, Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Request for Comment on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (Release No. IA-5955; File No. S7-03-22)

Dear Ms. Countryman:

Andreessen Horowitz ("a16z") appreciates the opportunity to comment on the U.S. Securities and Exchange Commission's (the "Commission") proposed rules relating to private fund advisers (the "Proposed Rules")[1] under the Investment Advisers Act of 1940, as amended (the "Investment Advisers Act"). a16z is an SEC-registered investment adviser and venture capital firm founded in 2009 with over $54 billion assets under management. We invest in U.S.-based companies in the technology, software, consumer electronic, social media, web3, gaming, biotech, and medical industries, among others.

The venture capital industry has an outsized impact on the U.S. economy. The importance of venture capital as a key driver of U.S. economic competitiveness cannot be overstated – it is essential to the U.S. economy and to the U.S.' status as a leader in innovation. A 2015 study published by researchers from Stanford University and the University of British Columbia concluded that 42% of all U.S. company IPOs since 1974 were venture-backed and they created $4.3 trillion in market capitalization, which represented 63% of total market capitalization of public companies formed since 1974.[2] Recent studies also demonstrate that employment at venture-backed firms grows at eight times the rate of non-venture capital backed U.S. companies.[3] Venture capital firms provide financial backing to early-stage companies that represent "moonshots" – companies that fundamentally transform industries, but which cannot obtain

1 Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Inv. Advisers Act Release No. IA-5955 (Feb. 9, 2022), *available at* https://www.sec.gov/rules/proposed/2022/ia-5955.pdf (the "Proposing Release").

2 Will Gornall & Ilya Strebulaev, *The Economic Impact of Venture Capital: Evidence from Public Companies* (2015) (Stanford Graduate School Business Research Paper No. 15-44), https://papers.ssrn.com/sol3/papers.cfm?abstract_id =2681841.

3 Gregory W. Brown, et al., *An Analysis of Employment Dynamics at Venture-Backed Companies Between 1990 and 2020*, VENTURE FORWARD (Feb. 2022), https://ventureforward.org/wp-content/uploads/2022/02/Employment-Dynamics-at-Venture-Backed-Companies.pdf.

sources of traditional financing because they challenge existing business models and practices and include a uniquely uncertain risk profile (that banks and traditional financiers may refuse to underwrite). Venture capital firms also provide valuable guidance, business connections and strategic advice to these young businesses.[4] Disruption of this vital financing source would threaten U.S. technological innovation across industries, which would have long-term effects on the competitiveness of the U.S. economy and national security.

The treatment of venture capital firms under the Investment Advisers Act represents a careful balancing between the need for investor protection and a regulatory framework that fosters competition and provides innovative firms access to capital at a critical stage in their lifecycles. We recognize and support the Commission's efforts to promote transparency, protect investors, and facilitate competition and efficiency. Private fund investors, even the most sophisticated and well represented, need transparency to evaluate their investments and effectively negotiate for contractual terms they regard as most favorable. However, private fund investors have a proven ability to exercise bargaining power and drive changes in a number of areas, such as increased fee and expense transparency. Market forces in the private fund marketplace have driven change in accordance with investor preferences for desired transparency and other outcomes, as illustrated by the increased uptake by some sponsors of bargained-for templates for the presentation of such information. Recognizing this, the Commission has historically taken a principles-based approach to the regulation of venture capital firms under the Investment Advisers Act, which relies on the primacy of full and fair disclosure and steps to address or mitigate conflicts of interest between the adviser and client.

The Proposed Rules represent a radical departure from this approach and would impose a set of requirements that, taken together, would effectively result in the rare imposition of substantive requirements and prohibitions on existing and future negotiated agreements between investment advisers and the sophisticated investors in their private funds. We have several concerns, which we outline below, regarding how this "sea change" may have unintended effects on the future health and vibrancy of the venture capital sector, specifically hampering the formation of new venture capital firms, and thereby leading to less diverse investment options for investors and less economic growth more broadly.

While not directed specifically, or solely, at venture capital firms, the Proposed Rule would have a significant impact on venture capital financing. Changes to the Investment Advisers Act arising from the Dodd-Frank Act implemented a requirement for many private fund advisers to register with the Commission.[5] As part of this effort and as directed by Congress, the Commission adopted a rule defining "venture capital fund" and providing a narrow exemption from registration for advisers solely advising such venture capital funds.[6] Despite this exemption, today many venture capital advisers are registered with the Commission as investment advisers, in part because of how the definition is designed and the fact that the venture capital industry, in response to market conditions, engages in investing strategies outside of private

---

4 *See* SEBASTIAN MALLABY, THE POWER LAW: VENTURE CAPITAL AND THE MAKING OF THE NEW FUTURE (Penguin Press, New York 2022).

5 *See* Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010) (the "Dodd-Frank Act").

6 Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Inv. Advisers Act Release No. IA-3222 (Jun. 22, 2011), available at https://www.sec. gov/rules/final/2011/ia-3222.pdf.

purchases of securities from issuers. Due to the Commission's inability to keep pace with market developments and keep venture capital fund advisers out of scope of Investment Advisers Act registration, the breadth and scope of the Proposed Rules in their current form would sweep in a broad diversity of advisers and private funds, including many venture capital firms, with potentially far-ranging and perhaps unintended economic impacts. The Proposed Rules take a one-size-fits-all approach and appear primarily designed to take into account the structure and operations of the major players in the private equity and hedge fund industry and their large investors (such as pension funds), who may be fiduciaries themselves. We are concerned that the Commission developed the Proposed Rules with limited outreach to many of the affected parties – including the venture capital industry – which might have yielded a more reasonably tailored, efficient and less costly set of requirements. We encourage the Commission, if it proceeds with an adoption of these rules, to make adjustments that either limit the scope of the rules or tailor them specifically to reflect these differences.

The Commission has presented no evidence of a market failure or fundamental flaws in the business model that would justify a regulatory intervention of this magnitude, particularly in the absence of any Congressional mandate, and has failed to substantiate the need for this overly prescriptive approach to private fund adviser regulation. Market forces have worked to improve the process of arm's-length negotiations of contractual terms between investment advisers in the venture capital space and their investors, a process that could be truncated if the Commission were to insert itself intrusively and unnecessarily into the inner workings of funds that are not registered investment products, and by Congressional design, should not be subject to similar types of regulation. As pointed out in many of the comment letters, from both sponsors and investors alike, we respectfully request that the Commission exercise extreme caution about the potential of the Proposed Rules to disrupt or fundamentally restructure longstanding and widely accepted practices in an investment option that has delivered enormous long-term financial benefits to investors and the nation.

Finally, we believe that a fundamental problem with the Proposed Rules is that they do not contain any provisions for "grandfathering" of contractual provisions that are currently in effect and may relate to funds that have been in operation for many years. Contractual terms do not exist in a vacuum. They are part of a larger whole that has been heavily negotiated and reflects the contours of a relationship that, unlike shareholders in a mutual fund, is often highly individualized to the specific investor. Removing or "reading out" a provision that has a significant influence on the economic terms of an existing relationship, such as an indemnification and exculpation provision, would necessitate a renegotiation of other terms, which would in turn be unduly burdensome, unfair, and massively disruptive. We urge the Commission, if it proceeds with an adoption, to limit the effect of the rules to contracts and agreements entered into after the effective date of the rules.

Recommendations for Specific Proposed Requirements

a. Liability Standard

The Commission should reconsider the proposed prohibition on exculpation and indemnification for breach of duty, willful misfeasance, bad faith, negligence and recklessness. The Commission takes the view that "by limiting an adviser's responsibility for breaching the standard of conduct, the incentive to comply with the required standard of conduct is eroded."[7] We believe the Commission's view is misplaced for several reasons.

First, we disagree that the standard indemnification provisions widely in use today, which reflect long-standing and accepted practice, create a moral hazard. Investment advisers already have very strong reputational reasons to avoid a fiduciary breach. Second, it would be inappropriate to institute a stronger prohibition in the case of private funds with highly sophisticated investors when the applicable standard for retail mutual funds expressly contained in the Investment Company Act of 1940, as amended (the "Investment Company Act"), is one of gross, rather than simple, negligence.[8] Because the Investment Company Act predates the Investment Advisers Act, there should be nothing about the Investment Advisers Act's standard of conduct that would dictate the outcome here, since all advisers, including advisers to mutual funds that can be indemnified for gross negligence, are subject to those same standards. Third, simple negligence, which can include inadvertent errors and mistakes, or other actions undertaken in good faith, is in stark contrast to the other intentional conduct and misbehavior included in the Proposed Rules, such as willful misfeasance.

Indemnification provisions for simple negligence are an almost-universal feature of private fund operating agreements. We believe investors have agreed to the prevailing market indemnification provisions because they not only recognize the strong reputational incentives to avoid fiduciary breaches, but they also understand that the market-standard indemnification provisions lead to lower fund operating costs, and that those cost savings are ultimately passed on to investors. The Proposed Rule would likely increase the cost of errors and omissions or other insurance premiums, which costs are typically allocated to private funds (and indirectly borne by investors) in the form of fund expenses. In addition, the increased costs will create friction for new entrants into the venture capital manager space and may result in the formation of fewer venture capital funds.

The Proposed Rules appear to ignore that these risk allocation provisions were not negotiated in isolation, but as part of a comprehensive bargain between sophisticated investors and investment advisers. For the Commission to interfere with such an established provision that represents years of iterative negotiations will undermine the whole enterprise of contractual negotiation. Raising the indemnification standard would impose additional costs on venture capital fund advisers, and such costs will be passed on to investors in the form of increased fund operating expenses, as well as higher incentive compensation charged by the adviser to compensate for the increased risk. The Proposed Rules do not seem to recognize that investors may have accepted these provisions because they provide economic benefits to investors due to their associated cost savings.

The proposed change to the liability standard would be particularly detrimental to the venture capital industry. Venture capital funds often invest in smaller early-stage companies that may not have the financial means to indemnify an adviser's investment professionals who serve on the boards of such companies. Service on the board of a portfolio company often means exposure to litigation risk from

7 Proposing Release at 151.
8 15 U.S.C. § 80a-17(i).

customers, investors, employees, business partners, vendors, lenders and regulators of such portfolio company. If the portfolio company cannot indemnify the advisory personnel for a breach of fiduciary duty, it often falls on the fund to indemnify those person(s). Investment advisory personnel can feel comfortable serving as directors of fledgling companies with the knowledge that if the company cannot meet its indemnification obligations, then the private fund will meet those indemnification obligations in its stead. This provides investment advisory personnel the security they need in order to serve on the boards of early-stage companies and is a risk management tool that protects the enterprise; the proposed change to the indemnification standard will have a chilling effect on advisory personnel's willingness to serve as directors of portfolio companies, which ultimately would have the effect of hampering economic growth.

Investors in venture capital funds are sophisticated investors who have a multitude of investment options available to them, and who can elect to forego investing in venture capital if they find the indemnification standard to be problematic. They instead choose to invest in venture capital, notwithstanding the market-standard indemnification provisions, because such firms have the proper incentives to take measured risks and have the flexibility to innovate, and thus provide exposure to a unique asset class. We urge the Commission to scale back the proposed liability standard to one of gross negligence and to consider the unique impact this proposal has on venture capital.

We believe this proposal represents a solution in search of a problem. In our experience, venture capital advisers already have significant reputational incentives to avoid a finding of a breach of fiduciary duties. Investors recognize these incentives and understand that an indemnification provision for simple negligence leads to cost savings and enables investment advisers and their personnel to take the measured risks necessary to deliver attractive returns.

b. Quarterly Statements

The Proposed Rules would require private fund managers to provide quarterly statements to private fund investors within 45 days of the end of each calendar quarter. The statements would include disclosures related to fees and expenses of the fund, portfolio investment level disclosure, and performance disclosure. As the Proposed Rules note, private fund advisers may currently provide statements to investors pursuant to contractual requirements with investors, but there is no requirement to do so under the Investment Advisers Act.

As stated above, we strongly support transparency, but believe that (1) the sophisticated investors in private funds already obtain the information they desire; (2) SEC-dictated disclosure will not be an improvement, will not accomplish its intended goal of achieving even "a degree" of standardization, nor can it fairly be described as principles-based and (3) aspects of the proposed quarterly reports are practically unworkable and need further tailoring, particularly for funds that are not typical examples of either a large hedge or a private equity fund.

Investors in private funds typically obtain both standardized and bespoke reporting. A private fund manager is typically incentivized to provide investors with fund reporting as it seeks to maintain a productive relationship with investors. In addition, investors, through an association that represents many of them, have promoted standardized investor reporting that has become commonplace in the private fund market. Any standardized reporting a private fund manager provides is frequently accompanied by bespoke investor reporting as well, which evidences the sophistication of the parties involved and the transparency of the market. The Proposed Rules add an additional layer of investor reporting on top of the established market- and investor-driven reporting. It is both unnecessary and burdensome, and the costs to create the quarterly reports will likely be passed on to investors who already can and do negotiate for the reporting they desire, in the format they desire, and often dictate the methods to calculate performance and other metrics, which vary from investor to investor. The Commission draws parallels to the much less voluminous and detailed standardized reporting of the registered fund space and summarily states that a similar approach is needed in the private fund space, which fails to acknowledge the differences between public and private markets and the option that an investor can choose to invest in a registered fund if it believes and values the reporting structure dictated by the SEC for that retail product. It is also worth noting that the Commission is focused on providing quarterly reporting to investors that have the sophistication, consultants and counsel to negotiate with private fund managers, but has no such requirement or proposed requirement under consideration for retail advisory clients that do not typically have the same leverage, acumen, and resources as sophisticated private fund investors. If there are transparency failures in segments of the private fund ecosystem, the Commission should identify those and take a more targeted approach to address those concerns.

The Commission's one-size-fits-all approach to the quarterly reports would also be difficult to implement as proposed. Adding additional standardized investor reporting on top of the already difficult task of closing fund quarterly financials will be a challenge for many advisers, particularly smaller and newer advisers. With respect to performance metrics, the Commission should not require unworkable standardized disclosure that may not be appropriate for all investment funds, but should instead continue to allow investors and private fund managers to negotiate how performance is reported.

c. Mandatory Audits

The Commission is proposing to require all SEC-registered private fund advisers to obtain an annual audit of the private funds they manage. The rationale for the rule is that the audit provides investors protection from misappropriation and a check on adviser valuation practices. The Commission proposes this change without providing support by either establishing a failure in the market for fund audits or widespread misappropriation or misleading valuation practices that need to be addressed. In addition, the new rule would create a confusing and misguided overlap to Investment Advisers Act Rule 206(4)-2 (the "Custody Rule") that seems both unwarranted and unnecessary – an overlap the Commission identifies, but curiously does not explain.

Consistent with many of the other provisions of the Proposed Rules, the Commission's proposed audit provision ignores the current dynamics of the private fund marketplace. For a number of reasons, including in part to address misappropriation risk and valuation processes, the vast majority of private funds with outside capital are already audited today. Private fund audits are largely the industry standard and are in place as a result of negotiations between sophisticated investors and private fund advisers, and not because of a government mandate. In fact, as the Proposed Rules note, the Custody Rule allows for compliance either through a fund audit or a surprise examination of the adviser. In light of the optionality provided by the Custody Rule for a surprise examination and the limited instances in which private funds are not audited today, it is very likely that those funds are unaudited because of a cost/benefit evaluation by the fund investors that suggests the cost of a financial statement audit is unwarranted for one reason or another. The Commission should not interject its judgment for investors, since it has not identified any market failure or widespread valuation problems in unaudited funds (and it should be noted that the surprise examination controls for misappropriation risk).

In light of the existing Investment Advisers Act rule that directly addresses private fund audits, it is perplexing as to why the Commission has proposed to layer another private fund audit provision on top of the existing rules. The justification for this novel approach has not been substantiated and will undoubtedly create unnecessary confusion for private fund managers and investors. If the Commission needs to address any particular private fund audit shortcomings that it can identify and support, the market would be better served to do so through an amendment of the Custody Rule, which we note already appears as an ongoing project on the Commission's own Regulatory Flexibility Agenda.

We conclude by reiterating our concerns about the ultimate economic consequences of the Proposed Rules, which would disproportionately burden new and emerging managers by creating significant barriers to entry, would raise costs and hinder efficiency, and would ultimately deter capital formation in the venture capital sector of the economy, which is the backbone of early-stage entrepreneurism. We urge the Commission to reconsider the breadth and reach of the Proposed Rules in view of these potentially damaging outcomes.

Respectfully submitted,

A.H. Capital Management, L.L.C.

By:

Jai Ramaswamy	*Scott Walker*
Jai Ramaswamy	Scott Walker
Chief Legal Officer	Chief Compliance Officer