National Venture Capital Association

January 24, 2011

VIA E-Mail

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C.20549-1090
rule-comments@sec.gov

Re: *Release No. IA-3110; File No S7-36-10, Rules Implementing Amendments to the Investment Advisers Act of 1940 (the Proposed Implementing Rules)*

Dear Ms. Murphy:

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) which, among other things, (i) amended the Investment Advisers Act of 1940 (Advisers Act) to eliminate the current exemption from registration for investment advisers with fewer than 15 clients, (ii) provided for a new exemption from registration for investment advisers solely to venture capital funds (VCF Exemption), and (iii) imposed certain reporting requirements on certain exempt investment advisers (Exempt Reporting Advisers) including those investment advisers exempt from registration under the VCF Exemption.

The Dodd-Frank Act required or authorized the Securities and Exchange Commission (the Commission or SEC) to adopt or revise certain rules applicable to investment advisers, including a rule defining a "venture capital fund" (VCF). The Commission set forth this definition in Release No. IA-3111 and the National Venture Capital Association (NVCA)[1] commented on that definition in a letter to you dated January 13, 2011.

The Dodd-Frank Act also directed the Commission to adopt rules relating to the reporting requirements applicable to Exempt Reporting Advisers. These are set forth in the Proposed Implementing Rules.

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1 The National Venture Capital Association (NVCA) represents more than 400 venture capital firms, comprising over 90% of all the venture capital under management in the United States. NVCA's mission is to foster the understanding of the importance of venture capital to the vitality of the U.S. and global economies, to stimulate the flow of equity capital to emerging growth companies by representing the public policy interests of the venture capital communities at all levels of government, to maintain high professional standards, and to provide research data and professional development for its members.

The NVCA is pleased to have the opportunity to comment on the Proposed Implementing Rules, with a specific focus on those rules' potential impact on the venture capital industry.

Given the historic and ongoing contribution of venture capital investing to the US economy, imposing the appropriate level of compliance burdens on that industry is important. The nature of these obligations will, in many ways, determine whether the venture industry can continue as a critical lynchpin in the nation's entrepreneurial ecosystem, one that has been a unique competitive asset to this country. Over 12 million U.S. jobs and nearly 20% of U.S. GDP can be traced to companies that were originally venture backed. In this light, while recognizing the mandate to protect investors and prevent systemic risk, the overall nature and magnitude of the obligations proposed by the Commission must be analyzed for the ultimate impact on the ability of the venture industry to continue to thrive.

In this spirit, the NVCA is seeking clarification from the Commission regarding its examination authority over investment advisers to VCFs. As noted by Commissioners Casey and Paredes in the open meeting during which this proposed rule was discussed, we believe the omission by Congress of a specific exemption for VCFs from SEC examinations was an unintentional technical oversight. Clarification of this point is critical so that Congressional intent to protect small VCFs from such regulatory processes is realized. Granting the SEC authorization to randomly examine venture capital firms would require significant resources on the part of the firms, effectively negating the overall registration exemption put forth in the Dodd-Frank Act. Our rationale and suggested approach follows.

Background

The venture capital industry has contributed disproportionately to U.S. economic growth which has differentiated the U.S. economy from all others across the globe. Since the 1970s, the venture capital community has served as a builder of companies, a creator of jobs, and a catalyst for innovation in the United States. According to a 2009 study conducted by econometrics firm IHS Global Insight, companies that were started with venture capital since 1970 accounted in 2008 for 12.1 million jobs (or 11 percent of private sector employment) and $2.9 trillion in revenues in the United States in 2008. Such companies include historic innovators such as Genentech, Intel, FedEx, Microsoft, Google, Medtronic and Apple.

We appreciate the implicit acknowledgement by Congress that SEC registration is not just filling out a form and submitting it annually. Registration under the Advisers Act requires the creation of a substantial infrastructure which would have easily cost small venture firms hundreds of thousands of dollars each year if they had been required to register. The additional regulatory requirements would have prevented venture capital firms from focusing time and financial resources on helping to start and grow new companies. Further, such registration requirements would not have provided the government with meaningful insight into systemic risk assessment. Ultimately, imposing regulatory requirements on venture capital firms would only have diverted government resources.

A venture capital firm typically employs a small administrative staff to handle firm operations. Often an investing partner will take on the role of Chief Administrative Officer and in that capacity will manage a Chief Financial Officer. The CFO is fully engaged in the financial operations of the firm, including the preparation of regular fund and portfolio company reports for VCF investors as well as all investor relations activities.

In addition to filing information regarding the identification of the firm, its partners and assets under management, the Advisers Act establishes a number of substantive requirements that would change the operation of a venture capital fund and the relationship between the venture capital fund and its limited partners. Many of these requirements would demand significant resources and overhead which sophisticated investors have not requested and that venture capital funds currently do not have in place.

The SEC can and does conduct periodic examinations of registered investment advisers. The SEC staff looks closely at, among other things, the registered investment adviser's internal controls, compliance policies and procedures, annual review documentation and books and records. SEC examinations may last anywhere from a few days to a few months and generally require a significant shift in firm resources to prepare for the examination, accommodate SEC requests during the examination, and resolve post-examination matters. The costs and administrative burdens associated with preparing for an examination can be substantial. The intent of these examinations is to evaluate the registered investment adviser's compliance with various policies and procedures imposed on registered investment advisers. Accordingly, we do not believe that requiring periodic examinations of venture capital firms would provide meaningful insight for the government's assessment of systemic risk; however, we do believe it would further divert the SEC's resources from the examination of advisers that do present systemic risk.

Moreover, since the Commission will retain its existing authority to address complaints against, and investigate suspected wrongdoing of, VCFs, and to file charges if it discovers a violation of a provision of the Advisers Act to which such VCFs are subject, such as the anti-fraud rules, the lack of an examination right should not unduly burden the Commission.

In exempting investment advisers solely to VCFs from mandatory registration, Congress recognized that venture capital investing does not pose systemic risk to the financial markets and that the time and costs associated with registration would place an undue burden on the industry. In granting this exemption, however, Congress gave the Commission the authority to require reporting and record-keeping by investment advisers to VCFs as determined by the Commission to be necessary or appropriate in the public interest or for the protection of investors. The NVCA has worked with the Commission throughout the legislative and rule-making process to voice the willingness of NVCA members to share an appropriate level of information necessary for the Commission to carry out its objectives without unduly burdening or putting at risk the competitiveness of VCFs.

Under the Proposed Implementing Rules, Exempt Reporting Advisers would be obligated to complete certain items on Part IA of Form ADV. Form ADV Part 1A would need to be updated at least annually and more frequently if certain information becomes inaccurate. The information would be publicly available on the Commission's website. The NVCA believes that the type of information required of Exempt Reporting Advisers under the Proposed Implementing Rules is generally acceptable to the venture capital industry, subject to our comments below. However, the NVCA does not believe that the Commission's examination authority over investment advisers to VCFs was intended by Congress nor do we believe it is appropriate. In fact, forcing venture capital firms to take the legal steps necessary to be prepared for an SEC examination is tantamount to requiring venture capital firms to undertake all of the obligations that would have been required if forced to register as investment advisers. The SEC's assertion of this authority acts to negate the Congressionally endorsed, statutorily mandated exemption.

<u>Comments</u>

Examination Authority

In its proposal the SEC states that:

> *Section 203(l) of the Advisers Act (which provides an exemption for an adviser that advises solely one or more "venture capital funds") … provide[s] that the Commission shall require such*

> *advisers to maintain such records,* ***which we have the authority to examine****, and to submit reports "as the Commission determines necessary or appropriate in the public interest". Under section 204(a) of the Advisers Act, the Commission has the authority to examine records, unless the adviser is "specifically exempted" from the requirement to register pursuant to section 203(b) of the Advisers Act. Investment advisers that are exempt from registration in reliance on section 203(l) or 203(m) of the Advisers Act are not "specifically exempted" from the requirement to register pursuant to section 203(b).*

While venture capital firms have historically been exempt from examination due to their exemption from registration under section 203(b)(3) of the Advisers Act, the Commission claims that Congress did not specifically amend section 204(a) to continue with this result under the new exemption. The Commission believes that such amendment is necessary to link the new VCF exemption under section 203(l) to the corresponding exemption from examination under section 204(a). If the Commission asserts this examination right, it would be exercising new examination authority over VCFs which, the NVCA believes, was not intended by Congress.

Examination authority was not articulated by Congress before, during or after the enactment of the Dodd-Frank Act as being a necessary component of the VCF exemption. Rather, significant discussion revolved around ensuring that VCFs would remain outside of the registration regime to avoid the burdens associated therewith, with Congress ultimately providing only that appropriate reporting and record-keeping requirements could be imposed. In fact, those new reporting and record-keeping requirements were specifically authorized by Congress in the law that it passed under section 203(l) with no mention of examination authority. The NVCA believes that the failure to connect the new exemption with the lack of examination right (in the same way that the existing exemption works) was unintentional and represents a technical oversight that can be corrected through Commission clarification in its final rule.

Clarification of this exemption is critical since the Commission's authority to conduct examinations of investment advisers to VCFs, especially on a surprise basis, would require significant resources on the part of the venture capital firms, effectively negating the benefit of the overall registration exemption set forth in the Dodd-Frank Act. We believe clarification is warranted because the stated VCF exemption delineates a clear intent by Congress to relieve investment advisers to VCFs from the burden of registration. An equal administrative burden would be created if the Commission were authorized to conduct surprise examinations of investment advisers to VCFs.

In addition, we do not believe that the lack of examination authority will create additional risk. Because there will be a requirement to file Part IA of Form ADV on an annual basis, the Commission will be regularly updated about the existence and general status of unregistered advisers to VCFs. The Commission will retain its existing authority to address complaints and investigate suspected wrongdoing of such advisers, as well as to file charges if it discovers a violation of a provision of the Advisers Act to which such unregistered advisers are subject, such as the anti-fraud rules. Therefore, there will be no undue burden on the Commission to launch an investigation if it believes it is merited.

Reporting Requirements

In its proposal the SEC also asked:

> *Should the reporting requirements be identical for Exempt Reporting Advisers as they are for registered advisers? Should Exempt Reporting Advisers be permitted to update Form ADV, or certain items, less frequently?*

The NVCA does not believe that it would be appropriate to require exempt investment advisers to VCFs to prepare or file additional Form ADV Part I or Part 2 information. In addition to a costly compliance burden, we do not believe that such information would provide relevant information regarding systemic risk given that VCFs will be limited to a narrow group of private funds that engage in activity that does not create such risk. Nor do we believe such information would be helpful to protect VCF investors since they are primarily sophisticated institutional investors who typically determine the information they need and acquire it directly from the investment adviser.

The NVCA believes that annual updates should be sufficient for Exempt Reporting Advisers, rather than requiring updates to be done "promptly" after any change. VCFs are long-term, illiquid interests in limited partnerships without withdrawal or redemption rights other than in extraordinary circumstances. There would be little, if any, benefit to investors, regulators or the public to receiving this information more frequently – especially given that investors typically negotiate to receive information regarding any material changes to similar information – but continuous Form ADV updates would be costly.

> *SEC: Are there items that we have proposed to apply to Exempt Reporting Advisers that we should not apply or are unnecessary, and why? Would any of these disclosure requirements, either individually or cumulatively, impose a significant burden? Is any of the information we propose to require not readily available to an Exempt Reporting Adviser? Will it be burdensome for … Exempt Reporting Advisers to use … the valuation hierarchy established under GAAP with respect to those funds that do not have financial statements prepared in accordance with GAAP?*

The NVCA believes that it would be unduly burdensome to provide U.S. GAAP valuation hierarchy information if the VCF's financial statements use a different basis of accounting. The financial reporting for a firm is governed by the written agreement between the VCF and its investors for each fund. At this time, the vast majority of U.S. VCF agreements specify U.S. GAAP reporting. But given the current review of U.S. GAAP, international convergence, and external investor requirements (*e.g.*, DOL/ERISA, international requirements), there is no guarantee that the U.S. GAAP basis requirement will continue indefinitely. There has been a significant amount of work and analysis undertaken by the global venture capital industry to harmonize valuation methodologies, but that has not yet occurred. For example, International Financial Reporting Standards (IFRS) and the International Private Equity Valuation (IPEV) board differ in their approach and principles from U.S. GAAP for purposes of valuing venture capital investments.

The time and effort placed in valuing illiquid companies has increased significantly over the past several years. Compliance by VCFs has been driven by the standards associated with the VCF's basis of accounting. Valuing an entire portfolio of portfolio companies for each VCF can be a daunting task because of the illiquid nature of the companies. To engage in this process twice using different principles would increase cost significantly without providing a corresponding meaningful benefit to investors.

In determining the importance of valuation principles to VCFs, it must be remembered that VCF economic arrangements and the venture capitalist's participation in the profits of the VCF are based on actual realization events (cash distributions from sales of companies or company stock distributions) rather than based on interim values of those companies.

> *SEC: Would any of the items require disclosure of proprietary or competitively sensitive information? If so, which items, and if competitively sensitive, describe the competitive impact. Would they require disclosure of proprietary or competitively sensitive information such that they could impact or influence business or other decisions by these advisers? Would the disclosure of*

> *private fund information by Exempt Reporting Advisers impact or influence business or other decisions by these advisers, such as whether to form additional private funds or discourage entry into management of private funds all together? In crafting these new disclosure items, we have sought to avoid requiring disclosure of proprietary information that could harm the interests of the fund or fund investors. Have we succeeded?*

The NVCA understands that it is the Commission's intent to include all information reported by Exempt Reporting Advisers on its website. While the NVCA generally believes that the provision of such information to the Commission, subject to its comments above, is appropriate, certain information may provide a competitive advantage to VCFs and their investors. As a result, while such information could still be provided to the Commission, the NVCA requests that it not be made publicly available.

Valuation. Information as to the gross and net asset values of a VCF (broken down by asset and liability class and categorized in the fair value hierarchy established under U.S. GAAP) may allow "reverse engineering" regarding valuations associated with particular portfolio companies and should not be publicly available. If so, those private-company valuations could affect pricing of additional rounds of financing and/or exit opportunities in a manner adverse to the VCF, its portfolio companies and its investors. Depending upon its interpretation by competitors, the dissemination of this information can also severely adversely impact a VCF's ability to "win" an investment, in that a VCF can be characterized as doing well or poorly, This possibility is heightened due to the break down by Level 1, 2 and 3 U.S. GAAP fair value hierarchies, especially when such information is provided over a number of years in connection with a limited portfolio of companies.

Investment Adviser Ownership. The VCF industry is quite small and the market for human resources is competitive. The disclosure of the investment adviser ownership, therefore, could give rise to competitiveness concerns across VCFs for the human talent within those advisers. While this type of information may be requested by and provided to investors in the VCF, those investors are typically subject to confidentiality agreements with the VCF or its adviser. If this information were made publicly available, the market for venture capital human resources could be adversely affected.

Private Fund Ownership. Public disclosure of the number of the private fund's beneficial owners and breakdown by category may allow a successful VCF's competitors to gain access to important information regarding the composition of that VCF's investor base. Fundraising for institutional investor commitments to funds is highly competitive, and even public dissemination of the category of investors that invest in a particular type of VCF could change the competitive landscape.

Control Persons. Public disclosure of control persons may reveal a strategic relationship to a competitor that adversely affects the VCF or its investors. Again, while investors may be entitled to this information and such information may be appropriate to provide to the Commission, the NVCA requests that such information not be made publicly available.

Conclusion

As stated in our January 13, 2011 letter to you, the NVCA believes that the requirements of your proposed VCF definition highlight that the venture capital industry operates in a manner that provides protection to its investors and imposes no systemic risk on the financial markets. As a result, registration would be an unnecessary and expensive burden to place on a small industry that spurs job creation, supports innovation and promotes economic growth for the nation.

Under the Proposed Implementing Rules, however, the examination requirement would create a similarly unnecessary and cost-prohibitive burden on the venture capital industry rendering the Congressional exemption meaningless. It would be an extremely unfortunate result if investment advisers to VCFs were compelled to leave or not join the industry because the examination requirement created a cost-prohibitive environment for continuing to invest into venture-backed companies or a barrier to entry for first-time venture capitalists. This result would neither protect the sophisticated institutional investors who have supported the current venture capital model for over 35 years nor would it enhance the stability of the financial markets. Rather, it would stifle innovation, economic growth and job creation at a time when Congress recognized the power of the venture capital industry to promote such goals.

Further, the public disclosure of certain information may cause significant adverse effects to the competitiveness of VCFs to the detriment of their investors and their portfolio companies.

We urge the Commission to consider our comments carefully, and we would be pleased to provide further input. Please do not hesitate to contact me or the NVCA's Vice-President of Federal Policy, Jennifer Dowling, at 703-524-2549.

Sincerely yours,

Mark G. Heesen
President