April 25, 2022

Vanessa Countryman, Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549
Submitted via email (rule-comments@sec.gov)

Re: File No. S7-03-22: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews

Dear Ms. Countryman:

eShares, Inc. d/b/a Carta, Inc. (Carta) appreciates the opportunity to comment on the Securities and Exchange Commission's (SEC or Commission) Proposed Rule, "Private Fund Advisers; Documentation of Registered Investment Compliance Reviews" (the proposal or proposal rules).[1]

Carta is a financial technology company that helps issuers, investors, and employees manage and value equity ownership. We do this by supporting the capitalization table for private companies, as well as providing portfolio management and reporting tools for thousands of investors and employees, and valuation and fund administration services to venture capital firms. Today, Carta has over 1,500 employees across the United States and abroad. Together we support over 1,800,000 stakeholders at more than 28,000 companies who manage over $2.5 trillion in equity value across Carta's platform.

Carta also provides fund administration services for more than 1,900 funds and 2,600 special-purpose vehicles, representing over $85 billion in assets under administration. Through Carta's fund formation business, we are working to lower barriers for new managers to enter the investment management space. This work uniquely positions Carta to assess the potential impact of the Commission's proposal on the venture capital industry.

Despite declines in 2020,[2] we saw first-time fund formations increase in 2021.[3] We are also seeing increasing geographic diversification in funds launched by new venture firms in

---

[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16886 (proposed Mar. 24, 2022) (to be codified at 17 C.F.R. pt. 275).
[2] *See* PitchBook, VC is performing better than ever. Then why are so few first-time funds being raised? (May 4, 2021), *available at* https://pitchbook.com/news/articles/vc-is-better-than-ever-why-so-few-first-time-funds.
[3] Carta Fund I report: 2021 year in review (March 8, 2022), *available at* https://carta.com/blog/fund-i-report-2021-year-in-review/.

regions outside of Silicon Valley and the East Coast.[4] This positive development is important and a trend we hope to see continue, as small and emerging fund managers are important sources of capital for earlier-stage companies, women- and minority-owned companies, and companies outside of traditional venture capital hubs.

The Commission's proposal would fundamentally change how the private fund industry operates and how it is regulated by the Commission. These changes would impact all private fund advisers: both SEC-registered private fund advisers and those Congress explicitly exempted from SEC registration, including advisers to small private funds and venture capital fund advisers.

While Carta supports many of the goals articulated in the proposal, including enhancing transparency, addressing conflicts of interests, and protecting investors, we are concerned about the potential impacts of the proposal on small and emerging fund managers, particularly in connection to their ability to raise capital and allocate resources to comply with the proposal. As a result, the proposal could reduce access to capital to founders in small businesses, especially those in traditionally underserved communities without access to established capital raising networks.

Our response: (1) respectfully requests the SEC to extend the comment period for the proposal; (2) highlights aspects of the proposal that could have negative impacts on small and emerging funds and the companies and founders they support; and (3) recommends adviser-led secondary transactions be exempt from the fairness opinion requirement if price is determined through market-driven forces.

1. ***Carta encourages the Commission to extend the comment period to allow for meaningful input on the proposal***

As a threshold matter, Carta echos the concerns of many other commenters[5] and respectfully requests the Commission extend the comment period deadline for this proposal. The proposal's abbreviated comment deadline does not provide sufficient time to thoroughly analyze and appropriately respond to a proposal that could have such a profound impact on the private fund industry and broad range of stakeholders. Also, this proposal does not exist in a vacuum; there are a number of other outstanding rulemaking proposals from the Commission that could significantly impact the private fund industry and broader financial system that must be analyzed and assessed simultaneously with this proposal, not to mention the comment

---

[4] *Id.*

[5] *See, e.g.*, Comment Letter of Representative Bill Foster, et al. (April 13, 2022), *available at* *https://subscriber.politicopro.com/f/?id=00000180-29a6-d749-ab92-b9bf20d30000* (as of the date of this letter, the referenced letter has yet to be reflected in the public comment file.); Comment Letter of Gail Bernstein, et al. (March 1, 2022), *available at* https://www.sec.gov/comments/s7-01-22/s70122-20118198-271109.pdf.

period's overlap with first quarter compliance and tax season. An extension of the comment period to provide reasonable time for thoughtful input, analysis, and substantive comment would benefit all stakeholders and further the interests of the Commission.

2. ***Carta encourages the Commission to consider potential implications on small and emerging funds, their investors, and the small businesses who rely on these funds as an important source of capital.***

The Commission's proposal has the potential to fundamentally change the operations of the private fund industry and will likely have a disproportionate impact on small and emerging fund managers, making it more expensive and onerous for them to raise and deploy capital. While the proposal would impose a number of new obligations on SEC-registered private fund advisers, it would ban a number of activities for all private fund advisers, including advisers to venture capital funds. A number of these provisions would represent a significant departure from common industry practice, and Carta is concerned about the potential impacts on small and emerging fund managers, who often lack ready access to capital and do not have the resources and scale available to meet new cost and compliance obligations.

Preferential treatment rule

The proposal would expressly prohibit certain types of "preferential treatment," or side letter agreements. Providing investors side letter rights is a common feature of venture capital funds, and the industry has well understood and developed processes for addressing them. Under Proposed Rule 211(h)(2)–3, investment advisers to all private funds would be prohibited from:

- 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 in the fund;
- Providing the ability for investors to redeem their interests on terms the adviser reasonably expects to have a material, negative effect on other investors in the fund; and
- Providing other types of side letter rights, such as opt-out rights or with respect to fees, unless the adviser provides advance written notice to prospective investors prior to the initial investment and annual written notice to existing investors in the fund.

New and emerging funds, which may not have a track record or access to an investor network, may struggle to attract capital. Bringing on an anchor investor can help signal a fund's credibility and bring more capital in the door. To land that critical anchor investor, however, the fund may need to establish a bespoke relationship agreement with special accommodations. By expressly prohibiting the use of certain preferential side letter terms, the proposed rule raises the barrier to entry to the private fund industry and will make it harder for emerging funds to attract and secure anchor and seed investors. This could have the unintended consequence of stifling capital formation, especially in traditionally underrepresented regions and communities.

<u>Prohibited activities rule</u>

Even if fully disclosed with investor consent and expressly authorized in fund governing documents, Proposed Rule 211(h)(2)-1 would prohibit all private fund advisers from:

- Charging certain fees and expenses to a private fund or portfolio investment, including accelerated monitoring fees; fees or expenses associated with an examination or investigation; regulatory or compliance expenses; or fees and expenses related to a portfolio investment on a non-pro rata basis;
- Reducing the amount of any adviser clawback by taxes applicable to the adviser;
- Seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of duty, willful malfeasance, bad faith, negligence, or recklessness in providing services to the private fund; and
- Borrowing from or receiving an extension of credit from a private fund client.

While some of the prohibited activities in the proposal are reflective of current or best industry practices, there are a number of provisions that would represent a significant departure from common industry practice and some of the most commonly used terms—terms that are often carefully negotiated between sophisticated parties and legal counsel. Carta is concerned that some of the proposed prohibitions could have the unintended consequence of chilling innovation and negatively impact investor returns.[6]

Notably, the proposal's ban on liability limitations could profoundly impact the venture capital industry and have a chilling effect on innovation. Negotiated agreements between the fund manager and investors will typically indemnify the adviser for any and all liabilities, costs, and expenses unless that liability arose from gross negligence, bad faith, willful misconduct, or material breach of the limited partnership agreement or applicable law.[7] The Commission's proposal is more expansive and would prohibit the adviser from being indemnified for simple negligence even though virtually all venture capital fund agreements contain such provisions. As a result, fund managers will face heightened liability that could negatively impact investment and business judgment decisions made by the adviser, which could have an overall chilling effect on innovation.

---

[6] The proposed ban of the use of tax-related carve outs for clawback provisions is contrary to another common provision in fund agreements, as managers and investors often agree that any clawback of an adviser's performance-based compensation should be limited on a post-tax basis.

[7] *See, e.g.*, "Carta's definitive guide to the LPA" (September 28, 2020), *available at* https://carta.com/blog/cartas-definitive-guide-to-the-lpa/.

Venture capital is about investing in and helping to guide innovative, transformative ideas from concept to flourishing enterprise. Fund managers support bold ideas at their earliest stages to help them succeed, and risk is inherent in this role. Venture capital fund managers are often involved in the activities of the companies they invest in, which requires a high degree of judgment. Being actively involved has benefits for both the fund and its portfolio companies but also creates more liability exposure. Heightened liability could chill a fund manager's willingness to take on such responsibility or be reflected in higher fees to account for such risk, both of which could negatively impact investor returns.

Additionally, prohibiting a fund manager from charging fees related to regulatory and compliance matters could create significant barriers to entry for first-time and emerging funds. As part of the governing agreement, initial investors in new funds may choose to bear expenses associated with regulatory compliance. Doing so helps incentivize investments in strong compliance functions. In addition, small and emerging funds may not have as ready access to capital and resources as larger and more established funds, so having the ability to charge these expenses to the fund—including the expenses associated with implementing this proposal—can be critical to survival, as these funds generally have tighter operating budgets. Not allowing funds and their investors the ability to negotiate the coverage of these expenses could create barriers to entry, particularly for underrepresented and emerging managers.

Due to the absence of grandfathering provisions in the proposal, the new requirements and prohibitions under the proposal would seemingly apply to existing contracts and agreements of all private funds on the date the proposed rules go into effect. As such, many existing negotiated agreements that reflect these common industry terms and practices may not be compliant at that time. Private fund advisers would have one year to modify their practices and the terms of existing funds to come into compliance, which could cause advisers to terminate existing funds early, raise new funds with compliant terms, or renegotiate agreements, which will likely increase costs and could lead to market disruption. As a result, investors could see higher fees, diminished returns, and portfolio company operations could be adversely impacted.

***

Overall, the proposal would expand the regulatory compliance obligations for all investment advisers to private funds, which could result in higher fees and impact returns for private fund investors. Increased compliance costs will likely have a disproportionate impact on small and emerging funds that do not have the operational scale and resources available to absorb these costs as readily as larger, more established funds. As a result, it will likely be harder for smaller and first-time funds to compete for capital, which could drive further concentration in the private funds industry.

We encourage the Commission to consider these potential implications on small and emerging funds, their investors, and the small businesses that rely on these funds as an important source of capital. In addition, Carta also encourages the Commission to devote attention to policies to help bolster access to capital for small and emerging funds, including recommendations made by the SEC's Small Business Capital Formation Advisory Committee.[8]

3. ***Carta urges the Commission to exempt adviser-led secondary transactions from the proposed fairness opinion requirement if price discovery can be achieved through a competitive process independent of the adviser***

Carta also appreciates the opportunity to comment on the proposed fairness opinion requirement with respect to adviser-led secondary transactions that offer investors the option to sell their interests in the fund or exchange them for new interests in another vehicle managed by the adviser. Under Proposed Rule 211(h)(2)-2, SEC-registered private fund advisers would need to obtain and distribute a fairness opinion from an unrelated third party prior to the closing of the transaction, and a summary of all material business relationships between the adviser and the fairness opinion provider. According to the proposal, requiring an independent written opinion stating the price being offered is "fair" would help address conflicts of interest where the adviser may be involved on both sides of a transaction.

Adviser-led secondary transactions can be beneficial to private fund investors by providing liquidity to investments that are typically illiquid and require long-term commitments of capital by investors. These transactions are optional, and investors are likely to participate if it better suits their needs. Carta believes liquidity is a critical component of investor protection, and any policies that could potentially deter adviser-led liquidity opportunities should be balanced against the impact on investor liquidity, which is already highly limited in the private funds space.

[8] For example, the SEC's Small Business Capital Formation Advisory Committee has recommended increasing the capital contribution limits and number of beneficial owners under the "qualifying venture capital fund" exemption in Section 3(c)(1) of the Investment Company Act of 1940 and permitting venture capital "fund of fund" investments. *See* Letter from Carla Garrett and Jeffrey Soloman, SEC Small Business Capital Formation Advisory Committee, to SEC Chair Gary Gensler (May 21, 2021), *available at* https://www.sec.gov/spotlight/sbcfac/encouraging-small-regional-funds-043021.pdf.

The Committee has also recommended the Commission provide alternative methods for individuals to qualify as accredited investors based on sophistication, including investment experience, knowledge gained through work experience or membership in associations, education credentials, additional professional certifications, or tests to demonstrate sophistication. *See* Letter from Carla Garrett and Jeffrey Soloman, SEC Small Business Capital Formation Advisory Committee, to SEC Chair Gary Gensler (March 12, 2022), *available at* https://www.sec.gov/spotlight/sbcfac/sbcfac-accredited-investor-recommendation-021022.pdf. Expanding the pool of accredited investors would expand a critical source of early-stage capital for small businesses across the nation.

In the proposal, the Commission asks: “Should certain adviser-led transactions be exempt from the proposed rule? For example, if the adviser conducts a competitive sale process for the assets being sold, which ultimately leads to the price, should advisers still be required to obtain a fairness opinion?”

If the goal of the fairness opinion requirement is to assist investors in determining whether the price offered is reflective of the value of the relevant assets held by the fund, the Commission should not require private fund advisers to obtain a fairness opinion when price can otherwise be determined through market-driven price discovery independent of the adviser. This process could include securities traded on an active market or when the price to sell interests in a private fund is determined through a competitive bidding process.

***

Thank you for the opportunity to comment on the proposal. If you have any questions, please contact Anthony Cimino, Head of Policy and Regulatory Affairs, at [redacted] or [redacted]

Sincerely,

Anthony Cimino
Head of Policy and Regulatory Affairs
Carta