May 8, 2023

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20548-1090

Re: Safeguarding Advisory Client Assets (Release No. 34-94062; File No. S7-02-22; Fed. Reg. No. 2023-03681)

The National Venture Capital Association (NVCA) is pleased to comment on the proposed safeguarding rule to amend and replace Rule 206(4)-2 (Custody Rule) under the Investment Advisers Act of 1940 ("Proposed Amendments" or "the Proposal").[1]

NVCA represents the U.S. venture capital (VC) and startup community. In 2022, VCs invested $240 billion in U.S. companies.[2] Our members provide the capital empowering the next generation of American companies that will fuel the economy of tomorrow. As the voice of the U.S. venture capital and startup community, NVCA advocates for public policy that supports the American entrepreneurial ecosystem.

Venture Capital Background and Economic Impact

Venture capital has enabled the United States to support its entrepreneurial talent by turning ideas and basic research into products and services that have transformed the world. Examples of venture-backed companies include Moderna, Genentech, Zoom, SpaceX, Ebay, and Amazon. Venture capitalists create partnerships with institutional investors to combine the capital held by pension funds, endowments, foundations, and others. VCs combine patient capital with their talent and expertise to make high-risk, long-term equity investments into innovative young companies.

Venture funds are generally partnerships that last ten to fifteen years, building investments far longer than any other asset class. VCs do not simply pick winners; they actively work with entrepreneurs to develop startups into successful companies. VCs work alongside the entrepreneurs,

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[1]Safeguarding Advisory Client Assets, Release No. IA-6240, Fed. Reg. No. 2023-03681 (Mar. 9, 2023).

[2] NVCA 2023 Yearbook, data provided by PitchBook; *available at* https://nvca.org/press_releases/nvca-2023-yearbook-u-s-vc-fundraising-reaches-new-heights-amid-industry-challenges/.

often taking board seats, providing strategic advice and counsel, opening their contact networks, and generally doing whatever they can to help their portfolio companies succeed.

A recent survey of companies backed by venture capital showed that four out of five respondents spent at least 70 percent of their total expenses on two activities: wages and compensation and research and development. This statistic highlights the extent to which venture capital finances job creation and innovation despite the risks inherent in funding companies expected to operate in revenue loss positions for years.[3]

Despite the long odds, venture capital is a major economic engine of job growth, spurs innovation, and creates new business models that change the world. New research found that employment at VC-backed companies between 1990 and 2020 grew 960 percent, whereas total private sector employment during that same period grew only 40 percent. VC-backed jobs are distributed broadly across the entire U.S. with 62.5 percent of VC-backed jobs outside the states of California, Massachusetts, and New York.[4] This illustrates a fundamental trend in the modern economy: the path to greater economic opportunity for American workers runs through technological progress and long-term investment.

Venture-backed companies comprise over half of companies that make initial public offerings (IPOs) each year (including 40 percent of climate technology companies),[5] are responsible for around half of new FDA-approved cures, and are causally responsible for the rise of one-fifth of the current largest 300 U.S. public companies.[6]

Summary

- The SEC should prioritize retaining the ability of venture capital fund advisers to effectively safeguard fund assets at the adviser level through self-custody.
- Both digital assets and privately offered securities are being appropriately safeguarded under fiduciary principles and the basic requirements of the current custody rule.
- Enhanced requirements for venture capital registered investment advisers, qualified custodians, and accounting firms would generate prohibitive costs, complexities, in some cases insoluble compliance issues for all venture capital funds.
- The proposed custody requirements for digital assets are unworkable and would drive venture investment in blockchain technology beyond U.S. jurisdiction.

[3] *Venture Capital Investment at Work*, American Startups and Job Growth Coalition (April 2021), *available at* https://nvca.org/venture-capital-investment-at-work/.

[4] *An Analysis of Employment Dynamics at Venture-Backed Companies Between 1990 and 2020*, NVCA, Venture Forward, and the University of North Carolina Kenan Institute of Private Enterprise (February 2022), *available at* https://nvca.org/wp-content/uploads/2022/02/Employment-Dynamics-at-Venture-Backed-Companies_FINAL.pdf

[5] *Initial Public Offerings: Updated Statistics*; Professor Jay Ritter, University of Florida; *available at* https://site.warrington.ufl.edu/ritter/files/IPO-Statistics.pdf.

[6] *The Economic Impact of Venture Capital: Evidence from Public Companies;* Illya A. Strebulaev, Stanford University Graduate School of Business and Will Gornall, University of British Columbia Sauder School of Business (July 2021); *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2681841.

- The cost and complexity of these new requirements may make it impractical for venture capital funds to self-custody any assets.

Proposed Amendments are Unworkable for Effective Custody of Venture Investments in Digital Assets

Venture capital plays a critical role in spurring economic growth through emerging technologies. Many NVCA members believe that blockchain holds the promise to be the next transformative industry, provided the policy environment allows entrepreneurs to fully experiment with the technology in the United States. The commercialization of blockchain technology is in its infancy, but a glimpse into current efforts of blockchain entrepreneurs offers a clear illustration of its potential. Currently, blockchain entrepreneurs are working to apply the technology to solve critical societal challenges like access to financial services for the unbanked and underbanked, expanding economic opportunity, fighting climate change, and providing a market-based solution to technology and financial services industry concentration.

The proposed amendments to the custody rule present steep challenges for VCs investing in digital assets. Crypto assets have several characteristics that distinguish them from traditional securities, posing challenges for traditional qualified custodians. Therefore, many early-stage tokens and other digital assets are safeguarded through self-custody, a common practice which we will discuss later in this response. Under the Proposed Rule, self-custody would be unavailable to protect any digital asset. Yet qualified custody options would be significantly narrowed while continuing to be incompatible with the unique technological aspects of many crypto assets. This would *reduce*, rather than increase, safe custody options for investing in digital assets. This could lead venture investors and custodians to diminish their role in or otherwise leave the digital assets market entirely, thus eliminating exposure of investors in U.S. funds to this asset class, hampering U.S. participation, and pushing innovation overseas.

The proposal to enhance requirements for privately negotiated contract agreements between advisers and custodians fails to appreciate its consequences. The required indemnification clause may be unworkable for both advisers and custodians and is inconsistent with the idea that custodians and advisers are best poised to negotiate allocation of liability. Such indemnification requirements may well eliminate the availability of custodians who would find insurance for such indemnification unavailable or otherwise cost prohibitive. This change alone would reduce, not increase, the availability of safe custodial options for investor assets.

Forcing digital assets into a framework that does not consider their unique technological aspects is likely at odds with an adviser's fiduciary duty obligations. For example, prohibiting advisers from working with custodians using the latest technological advancements could force consideration of less safe alternatives. This problem in particular highlights the need to allow for self-custody, which is the safest and most appropriate method of custody.

Further, the Proposed Amendments do not appear to have considered activities in which advisers make productive use of digital assets, e.g., participating in non-custodial ledger activities like staking,

voting in governance, etc.[7] This effectively prohibits advisers from accessing the safest and most effective disposition of such assets through digital asset exchanges, which may not be considered qualified custodians. Overall, this harms advisers' ability to meet their fiduciary duties and agreed upon investor preferences, outcomes, and expectations.

The SEC has made exceptions for asset classes with atypical features requiring differentiated treatment. A similar approach should be taken for digital assets. This proposal acknowledged that physical commodities and real estate merit pragmatic special consideration. We believe digital assets warrant a similar treatment which considers their unique technological features and logistical considerations.

Self-Custody is the Most Effective Means for Custody of Privately Offered Securities

The Release concedes that "self-custody … arrangements provide practical benefits for advisory clients…." (p. 82). In our experience, current rules as implemented by venture capital advisers to self-custody are sufficient to safeguard securities against any risk of loss or misappropriation.

Venture capital fund advisers, acting as fiduciaries for sophisticated investors, have developed their own procedures to ensure that each transaction in securities is safeguarded. A typical venture fund already has the following checks in place:

- Internal controls applied at the time of each transaction,
- Quarterly controls – review of updated capitalization table,
- Annual audit – internal controls review and reconciliation of fund and issuer records,
- Due diligence reviews completed by investors, and
- Use of third-party platforms to maintain ownership records.

The Release notes that "[w]hen this [privately offered securities] exception was adopted, the size of the privately held securities market was much smaller than it is now on an absolute basis as well as in relation to the size of the publicly traded securities market." (p. 130). While the Release suggests that this is a reason to narrow the current exception, we view this as evidence of its wisdom and continued vitality. The exception has been widely used and tested for privately offered securities and, to our knowledge, there has been no investor loss because of a custody failure at a venture capital fund.

Self-custody is a time-tested means for custody of privately offered securities. Adding new conditions to the exception substantially narrows the utility of the exception without reducing the risk of loss or misappropriation of assets. Therefore, the proposed new exception, as it would apply to a venture capital fund, should be modified significantly to make it workable for any asset held by a venture capital fund.

Proposed Amendments to "Private Securities Exception" Will Likely Eliminate the Ability of Venture Capital Funds to Self-Custody

The Release shows an SEC belief that custody with a qualified custodian would always be superior to self-custody of privately offered securities for advisory clients (p. 136-37). Each of the

[7] *Crypto Asset Custody by Investment Advisers After the SEC's Proposed Safeguarding Rule,* Scott Walker and Neel Maitra (March 2023), *available at* http://www.rscrpubs.com/Cover_Maitra_Walker__RSCR_3-22-23.pdf.

proposed new conditions for meeting the exception for "*Certain assets unable to be maintained with a qualified custodian"* reveal this bias by creating artificial difficulties and prohibitive costs.

The clearest example in the Release itself of a prohibitive cost is in the expansive new role of a public accountant that the Proposal contemplates. As part of the independent audit required by (b)(2)(v), the Proposal would require each asset to be individually verified by an independent public accounting firm. By the SEC's own estimate, the cost of this verification would reach nearly a third of a billion dollars (p. 313). The Release also notes that a shortage of accountants to perform such extensive audits could raise the initial cost beyond the "ongoing annual" cost estimate of $322,956,000. (Id.)

Similarly, the proposed requirement to document and notify auditors for every transaction is unnecessary and will cost far more than the estimated $21,000,000. Indeed, preliminary indications from accounting firms suggest that this cost alone could be prohibitive. Furthermore, given the controls already required by advisers' fiduciary duties noted above, there is no evidence that this oversight is needed to safeguard investor assets.

Additionally, the proposed requirement to "reasonably determine, and document in writing, that ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control of such asset" is too vague for a venture capital fund adviser to be assured of compliance. The Release offers neither a justification for this new requirement, nor adequate guidance as to the extent an adviser must prove and document the negative proposition.

Finally, in light of the extensive cost that this Proposal would impose on venture capital funds and their investors, a *de minimis* exemption is critical to avoiding a situation where a qualified custodian was mandated for small holdings of crypto, or any other asset. A grossly disproportionate cost-benefit balance is obvious here even assuming the most optimistic results of this Proposal.

Conclusion

NVCA urges the SEC to modernize and streamline the Proposed Amendments to retain venture capital fund advisers' ability to efficiently safeguard assets through self-custody. We appreciate the Commission's consideration of our comments and would be pleased to work on ways to amend the Proposal that would safeguard securities against any risk of loss or misappropriation but avoid the unnecessary consequences we have detailed.

Sincerely,

Bobby Franklin
President & CEO