National Venture Capital Association

July 28, 2009

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Rule-comments@SEC.gov

VIA EMAIL

Re: Release No. IA-2876; File No. S7-09-09: Custody of Funds or Securities of Clients by Investment Advisers.

Dear Ms. Murphy:

Introduction

The National Venture Capital Association (NVCA) is pleased to comment on the above-referenced Release ("the Release") and the proposed amendments to Investment Adviser Custody Rules ("the Proposals"). NVCA represents the vast majority of American venture capital under management.[1] NVCA member firms and the funds they manage provide the start-up and development funding for innovative entrepreneurial businesses.

Venture capital firms are generally not registered investment advisers. NVCA believes that the policy rationale for exempting venture capital from SEC registration remains valid and highly relevant.[2] However, because of the breadth of various legislative proposals that would expand the reach of SEC registration, we are providing comments on the proposed Custody Rules. We hope these comments will help the Commission understand the unique impact that

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[1] The National Venture Capital Association (NVCA) represents more than 460 venture capital firms – 90% of the venture industry. NVCA's mission is to foster greater understanding of the importance of venture capital to the U.S. economy and support entrepreneurial activity and innovation. The NVCA represents the public policy interests of the venture capital community, strives to maintain high professional standards, provide reliable industry data, sponsor professional development, and facilitate interaction among its members. For more information about the NVCA, please visit www.nvca.org.

[2] *See*, Testimony of Trevor Loy, Flywheel Ventures, Santa Fe, New Mexico, on behalf of the National Venture Capital Association, before the Senate Banking Subcommittee on Securities, Insurance and Investment Hearing, July 15, 2009, "Regulating Hedge Funds and Other Private Investment Pools." Available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=b4b5348b-ba91-4512-bca2-bf45b2e5fbde&Witness_ID=d372005d-927f-43bb-ac1d-41b5f820f477

these additional requirements would have on venture capital funds and their investors should they be enacted and applied to venture capital firms.

Background

The typical VC fund is organized as a limited partnership in which the venture capital firm serves as the general partner ("GP") and investment manager. Venture capital funds make the majority of their investments in the equity securities of private operating companies, normally referred to as "portfolio companies." The vast majority of these portfolio companies are Subchapter C corporations. Some portfolio companies are in partnership or LLC form, especially foreign investments. We believe that a substantial portion of these venture-backed portfolio companies issue shares in certificate form.

Nearly all of the investment capital in VC funds -- 95 to 99 percent -- comes from qualified institutional investors such as pension funds, universities and endowments, private foundations, and to a lesser extent, from high net worth individuals. Venture capital investors own a limited partnership interest which represents an undivided interest in a partnership holding a pool of private company securities. These interests are subject to numerous rights and obligations set out in the partnership agreement and other relevant documentation. The typical life of a VC fund is ten years and partnership interests are highly illiquid and rarely redeemed.

The typical venture capital fund's audit and financial reporting practices reflect the requirements of their institutional limited partner investors ("LPs"), which are set out in the partnership agreement. The vast majority of venture capital funds provide their LPs quarterly and audited annual financial reports. These reports are prepared under generally accepted accounting principles, or GAAP, and audited under the standards established for all investment companies, including the largest mutual fund complexes.[3] As far as we can determine, all VC fund audits are conducted by independent public accountants registered with, and examined by, the Public Company Accounting Oversight Board (PCAOB).

The custody arrangement for fund assets is generally determined by the type of assets. As noted, VC funds focus their investments on private companies in their start-up or growth phase. Therefore, the vast bulk of fund assets are unlisted, nontradeable, restricted or otherwise illiquid. Other assets such as marketable securities and cash are typically held by broker dealers or banks, i.e., "qualified custodians."[4]

This standard audit of a VC fund includes a thorough review of these custody arrangements, including a physical inventory of privately-issued securities in the firm's possession and/or a direct confirmation with the issuing portfolio company.

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[3] *See generally,* AICPA Audit and Accounting Guide, *Investment Companies,* AAG-INV 2.174 (May, 2009)
[4] VC funds do not hold large amounts of either publicly-traded securities or cash. Once securities are marketable, they are either distributed to investors or sold in order to facilitate a cash distribution. Investors provide cash to the fund though "calls" only when a future portfolio company has been identified and investment in that company is imminent.

Comments on the Proposed Amendments

We are responding primarily to the Release's request for comment in Part B on "the practical aspects of requiring advisers that have custody to maintain client assets with an independent qualified custodian" and the cost-benefit of a surprise examination. Our comments are further narrowed to the unique circumstances of venture capital funds assets – primarily privately-issued securities.

We appreciate of the goals of the Proposals. We support practices that ensure appropriate safekeeping of investors' assets and independent oversight sufficient to minimize the risk of fraud or negligent loss of fund assets. Upon review of the Proposals and current VC firm custody practices, NVCA believes that the existing financial reporting practices and partnership obligations of the typical venture capital firm, as described above, are sufficient and consistent with goal of ensuring the safe keeping of LP's interests in VC funds. Therefore, there are elements of the Proposals we see as costly and redundant for safeguarding investor assets.

Independent Audit of Internal Controls

The Proposals would give registered investment advisers the option of a Type II SAS 70 audit in lieu of the requirement to have fund assets in the custody of an independent qualified custodian. As the Commission is probably aware, this type of audit of internal controls is a significant expense for even large investment advisers. In the venture capital universe, it would be prohibitively expensive for the vast majority of firms.

Based on the $250,000 average annual audit estimate in the Release, the Type II SAS 70 audit would cost approximately $115,000,000 per year just for NVCA member firms. This cost, as with a number of other cost burdens associated with Adviser Act registration would have a dramatically negative effect on venture investing and especially on fledgling venture capital firms. The loss of these newer and smaller firms would narrow the sources of funding for innovative companies in new industries. It would also limit the investment opportunities of LPs and reduce competition within the venture world. In the final analysis, it would impede entrepreneurship and economic growth.[5]

Furthermore, the Type II SAS 70 audit would provide very little additional protection for investors beyond the current, standard GAAP audit that includes a complete reconciliation of all securities positions and other assets. Therefore, the cost of such a procedure is wildly out of proportion to its benefits for venture investors.

Independent Qualified Custodian

The requirement to have an independent qualified custodian for publicly-traded securities and cash is an appropriate, cost-effective safeguard. However, with respect to privately-issued

[5] Venture Capital is proven source of innovation and economic growth. 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. Testimony of Trevor Loy, *supra*, note 2, at page 4.

securities, including those held in certificate form, the independent custodian would add little additional safeguard for the investor.

As noted, the typical venture capital firm provides financial statements on an annual and quarterly basis, prepared in accordance with GAAP. These reports to LPs are based on valuations audited by PCAOB-registered CPAs. Annual audits include a physical inventory of assets such as privately-issued securities in the firm's possession and/or direct confirmation with the portfolio company. Because of the nature of privately-issued securities we do not see the independent custodian adding any incremental protection beyond that provided by the GAAP audit.

As noted, GAAP requires the fund's general partner to value the funds assets and those valuations are audited. By virtue of the fact that the private company securities are not tradable, the custodian is not able to provide any indication of the value without input from the fund's GP and their auditor. Since the custodian would receive input only from the people who are already engaged in the process of valuing assets and reporting to their limited partners, the custodian does not provide any significant incremental protection.

Therefore, we believe the removal of unlisted, restricted, non-tradable and illiquid private company securities from the VC firm's possession to an outside custodian would add a layer of administrative burden, cost and delay while providing no incremental safeguard of VC investors' assets.

Surprise Examination

For many of the same reasons, we believe that the addition of the requirement for a surprise examination by an independent CPA would add little incremental investor protection for venture capital limited partner investors.

As noted, only highly illiquid securities are typically held in the custody of a venture capital firm and the standard audit of the firm includes a complete physical inventory of privately-issued securities in the firm's possession and/or a direct confirmation with the issuing portfolio company.

Conclusion

NVCA believes that the following custodial safeguards are appropriate for venture capital firms and the sophisticated investors they serve:

- Qualified outside custodian of publicly traded securities and cash;
- Annual GAAP audit of all funds;
- Audit conducted by a PCAOB-registered independent certified public accountant;
- Annual audits include a physical inventory of privately-issued securities in the firm's possession and/or a direct confirmation with the issuing portfolio company; and
- Annual and quarterly reporting to limited partner investors based on GAAP valuations.

We hope that our comments are helpful to the Commission in evaluating its Proposals as they apply to other types of investment firms. We also hope that this information aids the Commission in developing an appreciation for the unique impact that registration in general and these Proposals in particular would have on venture capital.

Very truly yours,

Mark G. Heesen
President