February 14, 2020

VIA ELECTRONIC DELIVERY

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: **Investment Adviser Advertisements; Compensation for Solicitations**
SEC Rel. No. 1A-5407; File No. S7-21-19

Dear Ms. Countryman:

On behalf of our members, we are pleased to submit this letter in response to the request by the Securities and Exchange Commission ("Commission") for comments regarding the proposal to amend Rule 206(4)-1 and Rule 206(4)-3 under the Investment Advisers Act of 1940 ("Advisers Act").[1]

The National Venture Capital Association (NVCA) represents participants in the venture capital and start-up community, including investment advisers to venture capital funds. Our members provide the capital empowering the next generation of American companies that will

[1] *Investment Adviser Advertisements; Compensation for Solicitations*, Investment Advisers Act Rel. No. 5407 (Nov. 4, 2019) (the "Proposing Release").

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.

Summary

The NVCA supports the Commission's effort to modernize Rule 206(4)-1 (the "advertising rule") and Rule 206(4)-3 (the "cash solicitation rule"). However, we strongly oppose the Commission's proposal to broaden both rules to the extent that it will result in the regulation of the offering of securities by venture capital funds and other private funds. Capital-raising activity by private funds is already sufficiently regulated under the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act"). Additionally, the broker-dealers firms and their registered representatives are separately, and extensively, regulated under the 1934 Act and by FINRA's rules.

The proposed new, duplicative layer of regulation is unnecessary to protect the sophisticated high net worth and institutional investors in venture capital funds and most other private funds, and will impede the ability of these funds to raise capital by placing additional costly regulation on them. We hope that the Commission, which only recently proposed rules easing the ability of venture capital and other private funds to raise capital,[2] will reverse course and avoid simultaneously increasing burdens on the same capital raising activities.

Interests of Venture Capital Fund Advisers

Both the advertising rule and the cash solicitation rule apply only to advisers registered with the Commission under the Advisers Act. Most advisers to venture capital funds are not

[2] *Amending the "Accredited Investor" Definition*, Securities Act Release No. 33-10734 (Dec. 18, 2019).

registered in reliance on the exemption in Section 203(*l*) of the Act for advisers to venture capital funds. However, a growing number of our members are registering because Rule 203(*l*)-1, which defines the term "venture capital fund," has not kept up with market developments since it was adopted in 2011.[3] Consequently, a growing number will be *directly* affected by the rule proposal.

Many other members will be *indirectly* affected by the proposal insofar as the additional regulatory burdens and costs would deter them from registering under the Advisers Act. As a consequence, if the rule amendments are adopted as proposed, many of our members that are currently "exempt reporting advisers" will continue to confine their business to venture capital investing as defined narrowly by rule 203(*l*)-1, limiting their potential to provide capital to growth companies that contribute to the American economy.

The Advertising Rule

Rule 206(4)-1 has, since 1961, applied to written communications by investment advisers that solicit securities advisory services.[4] The Commission proposes to expand the scope of the rule to include any communication that "seeks to obtain or retain . . . one or more . . . investors in any pooled investment vehicle advised by the investment adviser."[5] The term "pooled investment vehicle" would include private funds, including all venture capital funds.[6]

[3] For example, secondary share purchases, COIN offerings and investments in other venture capital funds are not treated as a qualified investment for purposes of rule 203(*l*)-1. The NVCA submitted a letter to the Division of Investment Management in November 2018 suggesting several changes in the rule to modernize its provisions.

[4] Rule 206(4)-1(b). The definition of advertisement is broadly written in paragraph (b) of the rule but, in substance, is expressly limited as discussed above.

[5] Proposed Rule 206(4)-1(e)(1) (defining "advertisement').

[6] Proposed Rule 206(4)-1(e)(9).

No Commission or staff interpretation of which we are aware (or any interpretation cited in the Proposing Release) has applied the advertising rule to communications that offer investments in a private fund advised by an adviser.[7] This makes sense because private funds solicit for investors to invest in the funds rather than clients for advisory services. As the D.C. Circuit's opinion in *SEC v. Goldstein* made clear, it is the private fund that is the client of the adviser rather than the fund investors.[8]

The Commission supports this significant expansion of the advertising rule by analogizing it to Rule 206(4)-8, which prohibits an adviser from defrauding investors in a pooled investment vehicle it advises. But reference to Rule 206(4)-8 only serves to confirm that the Commission already has broad authority under the Advisers Act to prosecute fraud by advisers on investors in private funds. The purpose of this aspect of the proposal thus appears to be only to impose the Rule 206(4)-1 regulatory overlay on private fund offerings.

Rule 206(4)-8 was adopted in 2007 in the wake of the *Goldstein* opinion, which suggested that, because fund investors are not clients of an adviser, the Commission could not bring enforcement actions under Section 206(1) and (2), the principal anti-fraud provisions of the Act, both of which prohibit fraud against *clients*. The opinion left the Commission unable to bring any anti-fraud actions against some types of frauds by advisers that had not occurred "in connection with the purchase and sale of a security" so that an action under Rule 10b-5 was

[7] The staff has expressed the view that the advertising rule does not apply to documents offering of shares of mutual funds unless they are directed for the purpose of referring advisory services. *Munder Capital Mgmt*., SEC Staff No-Action Letter (May 17, 1996).

[8] 451 F.3d 873 (2006). To the extent lawyers (and compliance examiners) have advised registrants that the advertising rule is applicable to offerings by private funds, we suspect it is either (i) because the adviser is also offering separate accounts as an alternative investment to private funds, or (ii) leftover from analysis that pre-dates the *Goldstein* decision in which the Commission took the position that the investors in the funds were clients of the fund's adviser.

unavailable.[9] Rule 206(4)-8 was designed to fill a hole in the Commission's anti-fraud authority, not to impose additional regulation on private offerings of private funds. Indeed, despite the objections of some commenters, the Commission declined to adopt a rule that addressed more narrowly-defined conduct.

There is no suggestion of such a hole in the Commission's ability to police misleading securities offerings by private funds. Such offerings are subject to both the 1933 and 1934 Acts, which expose issuers to considerable liability for misleading statements, including private rights of action. Moreover, the private placement regime under which all of the private funds operate assures that all of the investors are "accredited investors" or, in many cases, "qualified purchasers," and thus are assumed to possess a level of knowledge and sophistication the Commission has itself concluded are sufficient to forgo the protections of many of the prophylactic provisions of those statutes, as well as the Investment Company Act.

Application of the proposed regulatory overlay would impose substantial new burdens on venture capital funds. Although the Commission described the proposed amendments as replacing rule's current restrictions with more "principles-based" provisions, there are hundreds of pages of "principles" in the release, which our members will need to engage counsel to sort out when preparing marketing material and later, when a compliance examiner arrives with their own interpretation of the "principles."

One of the new risks that concern us is the *multiple* new standards under which private fund marketing material would now be evaluated under a proposed new section of the rule

[9] *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, Investment Advisers Act Release No. 2628 (Aug. 3, 2007) (adopting rule 206(4)-8). An "account statement fraud" might occur, for example, when an adviser provides the fund's limited partners misleading information about the performance of their accounts during a period in which there was no fundraising.

entitled "General prohibitions," including a new provision that prohibits any material claim or statement that is "unsubstantiated." We will discuss only one in this letter to illustrate our concern.

Currently, the Commission (in a recordkeeping rule) requires only performance information included in marketing material to be substantiated, and includes an important safe harbor for compliance with the requirement.[10] The new provision would require *all* material facts in marketing material to be substantiated, but it is unclear as to what records would be necessary (or, more importantly, would be acceptable to one of our members' compliance examiner) to substantiate any particular fact. Our members' marketing material often includes information about dozens of portfolio companies and the many markets in which they compete. To what extent and at what cost will our member be required to substantiate all of this material? And what forms of substantiation will be sufficient? Moreover, how can an adviser's views on the markets or particular issuers ever be substantiated? If the Commission adopts these amendments and fails to answer these questions, our members will have to engage counsel to struggle with them.

We appreciated that un-substantiated claims about the adviser's skills or the performance of the private fund in an offering document may be misleading and a violation of the various anti-fraud provisions.[11] But that is very different proposition than a requirement that every material fact in an advertisement must be substantiated. First, such a requirement may have the effect of shifting the burden of proof from the Commission to the adviser as to whether the facts

[10] Rule 204-2(a)(16).

[11] See Rule 156(b)(3)(ii) under the 1933 Act.

stated are misleading.[12] Second, as a practical matter, it raises the question of what types of documents are sufficient to substantiate all the types of material statements that may be included in marketing material.[13] Would information provided by portfolio companies be sufficient? Third, advisers will be constrained from communicating non-misleading information to prospective investors where there is some doubt about the amount of substantiation required by the rule.

While this burden shifting may be appropriate in the limited context of performance information, it presents a potentially enormous new burden on registered advisers, will interfere with the free communication of non-misleading information, and expose advisers to substantial new legal risks.

Cash Solicitation Rule

Rule 206(4)-3, the cash solicitation rule, is designed to address the conflicts posed when an adviser pays another person to solicit or refer clients to the adviser. The rule principally requires disclosure to prospective clients of these conflicts, requires the adviser to exercise certain supervisory responsibilities over the solicitor, and prohibits use of solicitors that have engaged in certain disqualifying conduct. The Commission proposes to extend the cash solicitation rule to payments by registered advisers to persons (*i.e.*, placement agents) who promote the sale of fund shares.

---

[12] *Warwick Capital Mgmt., Inc.*, Investment Advisers Act Rel. No. 2694 (Jan. 16, 2008) (Commission Opinion stating that the Rule 204-2(a)(16) operates to shift the burden of proof regarding a violation of the advertising rule, requiring an adviser that cannot produce records to refute the SEC staff's (or its expert's) assertions of actual performance.)

[13] This was an issue the Commission addressed when it adopted the substantiation rule in rule 204-2(a)(16) and led to the adoption of the safe harbor. *Recordkeeping by Investment Advisers,* Advisers Act Release No. 1135 (Aug. 17, 1988).

In the context of venture capital funds and other types of private funds, such payments (at least domestically) are made to registered broker-dealers, which thereby receive transaction-based compensation for the sale of a security. These broker-dealers are regulated extensively under the provisions of the Exchange Act and FINRA rules designed, among other things, to address conflicts of interest.

The Commission acknowledges regulation of broker-dealers in the Proposing Release, explaining that "prospective investors in RICs and BDCs sold through a broker-dealer or other financial intermediary already receive disclosure about the conflicts of interest that may be created as a result of the fund or its related companies paying the intermediary for the sale of its shares and related services."[14] It is not at all clear to us, therefore, on what basis the Commission has concluded that prospective investors in private funds sold through the same broker-dealers subject to the same broker-dealer rules require different treatment and why an extension of Advisers Act regulation into customary broker-dealer activities is needed.

Since 2008, advisers to venture capital funds and other private funds have relied on an SEC staff letter, which interpreted the cash solicitation rule as not applying to cash payments for soliciting investors to private funds.[15] That letter was based, in part, on the decision in *Goldstein*, in which the court reasoned that investors in private funds could not reasonably be considered to be "clients" of the private fund's investment adviser.[16]

The proposed rule would override both the staff letter and the reasoning of the *Goldstein* opinion. The NVCA does not challenge the Commission's authority to adopt the proposed rule

[14] Proposing Release at 210.

[15] *Mayer Brown LLP* (July 28, 2008).

[16] *SEC v. Goldstein*, *supra* note 8 at 881.

but, as with the proposed amendments to the advertising rule, does not believe that an adequate case has been made for the need for overlapping and duplicative regulation of the securities offerings of private funds. The Proposing Release identifies no particular problems with solicitations of private fund investors that has occurred since 2008, nor does it make any kind of a case that the Commission has insufficient authority to address such problems under the Exchange Act. The Commission should treat broker-dealer solicitors of private funds in the same manner that it proposed to treat broker-dealer solicitors for RICs and BDCs.

The NVCA strongly urges that if the Commission adopts the proposed amendments to the investment adviser advertising and cash solicitation rules, it does so without provisions that expand each rule to regulate the private offerings of securities by private funds, including venture capital funds. As we have noted above, these activities are properly regulated under the 1933 Act and 1934 Act and by FINRA, and the application of two Advisers Act rules designed to apply in other contexts (*i.e.*, to the solicitation of advisory services to clients rather than the sale of investment products to investors) would impose duplicative and unnecessarily burdensome regulation on the capital raising activities of these funds and their advisers.

* * * * *

We appreciate the Commission's consideration of our comments on these proposals and would be happy to provide an additional information that may be helpful.

Respectfully submitted,

Bobby Franklin
President & CEO

Cc: The Honorable Jay Clayton
The Honorable Hester M. Peirce
The Honorable Elad L. Roisman
The Honorable Allison Herren Lee

Dalia Blass, Director, Division of Investment Management