June 4, 2018

The Honorable Jeb Hensarling
Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Bill Huizenga
Chairman
Committee on Financial Services
Subcommittee on Capital Markets, Securities & Investment
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Carolyn Maloney
Ranking Member
Committee on Financial Services
Subcommittee on Capital Markets, Securities & Investment
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Hensarling, Ranking Member Waters, Chairman Huizenga and Ranking Member Maloney:

On behalf of the Institutional Limited Partners Association (ILPA)[1], we are writing this letter to relay our significant concern about draft legislation[2] considered at the recent hearing entitled *"Legislative Proposals to Help Fuel Capital and Growth on Main Street"* of the Subcommittee on Capital Markets, Securities & Investment, on May 23, 2018. This draft legislation (Proposed Bill) would considerably expand the scope of the current exemption for venture capital (VC) advisers, permitting many private fund advisers that are not engaged solely in VC-type investing activities to evade SEC oversight, while potentially permitting other private fund advisers to de-register from the SEC.

This legislation presents a slippery slope to further erosion of the SEC registration requirement, a requirement that has delivered significant value to both private fund advisers and limited partners (LPs) invested in many types of private funds. We also believe that this expansion runs counter to Congress' fundamental rationale for creating the VC exemption in the Dodd-Frank Act when the law was enacted. Further, rather than encouraging more capital formation, expanding the VC exemption degrades the quality of disclosures and transparency, and potentially erodes investor confidence in this important asset class. The resulting increased complexity of portfolios resulting from expanding the VC exemption warrants greater oversight, not less. As a result, we encourage you to consider the views of the ILPA's members, the fiduciaries for tens of thousands

[1] The Institutional Limited Partners Association (ILPA) is the only organization dedicated exclusively to representing the interests of institutional investors in private equity, otherwise known as limited partners (LPs). Our 460+ member institutions include public pension funds, corporate pensions, insurance companies, university endowments, charitable foundations, family offices and sovereign wealth funds, all of whom invest in the US private equity market. Our members represent over $2 trillion in private equity assets under management, about half of the capital in the asset class, and represent first responders, teachers, state and municipal workers, insurance policyholders, scholarship recipients and others. The ILPA's members provide the capital that fuels private equity and venture capital investment, generating significant economic growth and job creation, across America and around the world.

[2] The draft legislation is titled "H.R. ___, To require the Securities & Exchange Commission to revise the definition of a qualifying portfolio company to include an emerging growth company, for purposes of the exemption from registration for venture capital fund advisers under the Investment Advisers Act of 1940."

of Americans, before further considering moving forward with this legislation. There should be further study on such a dramatic change to the status quo, which is working well and has resulted in a strong, healthy private fund market which is driving significant capital formation and economic growth.

I. Overview of the VC Exemption

The VC exemption constrains the information access and transparency benefits provided to investors by the SEC registration requirement. The VC exemption was inserted into the Dodd-Frank Act as a way to create a much lower regulatory standard for those private fund advisers pursuing a true VC strategy, i.e., investing in start-up and early-stage companies.[3] VC advisers are therefore excused from SEC examination, and many of the regulations with which most private fund advisers have to comply, e.g. firms pursuing later stage strategies such as growth equity or private equity (PE). This different placement in the regulatory structure is tied to the early-stage strategy of the fund, even though the underlying structure and governance characteristics of VC funds are typically quite similar[4] to that of PE funds.

The considerations of LPs investing into both VC and PE funds are also similar, particularly around adequate disclosure of costs, conflicts of interest and governance matters. In both cases, the LP seeks assurance that the private fund adviser, whether advising a VC or a PE fund, is adhering to the terms of the limited partnership agreement (LPA) negotiated with their investors. Among the chief benefits of SEC registration for private funds is a general trend in favor of enhanced transparency and disclosure and greater confidence in an adviser's compliance with the agreed investment strategy and the LPA, for the benefit of all investors. As a consequence, LPs have greater confidence in private funds and have invested more money in the private markets than at any time in history.[5] According to McKinsey, assets under management in private markets have reached a record level of $5.2 trillion in 2017, up 12% from 2016's $4.7 trillion, with AUM growth accelerating in 2015-2017.[6] VC advisers, however, operate beyond this oversight and in general provide investors with a lower level of transparency relative to registered funds.

By expanding the ability of exempt advisers to invest in publicly reporting Emerging Growth Companies (EGCs), as is contemplated in the Proposed Bill, more private fund advisers would remain beyond the sunlight of SEC registration. This expanded scope of exemption would primarily benefit larger VC Advisers who are investing in more complex assets, e.g. publicly held companies, with significant assets under management, or, more worryingly, other private fund advisers who are seeking to fit their strategy into the expanded VC exemption that is being proposed. This proposal neither benefits investors in these funds, nor does it lead to better outcomes or encourage investment into publicly held EGCs. Chipping away at the requirement

[3] The SEC states that "As a general matter, venture capital funds are long-term investors in early-stage or small companies that are privately held, as distinguished from other types of private equity funds, which may invest in businesses at various stages of their development including mature, publicly held companies." *See* 75 Fed. Reg. 77190, Proposed Rule: U.S. Securities & Exchange Commission, *Exemption for Advisers to Venture Capital Funds, Private Fund Advisers With Less than $150 Million in Assets Under Management, and Foreign Private Advisers*. *Available at:* https://www.sec.gov/rules/proposed/2010/ia-3111fr.pdf

[4] The primary difference between a VC adviser and a PE adviser is their strategy - that VC managers invest in companies earlier in their life cycle, while PE managers invest later in the company's life. While smaller VC managers may present less complexity to oversee, with most VC advisers, many of the challenges are similar.

[5] McKinsey Global Private Markets Review 2018, *The rise and rise of private markets,* McKinsey & Company, *available at: https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/the%20rise%20and%20rise%20of%20private%20equity/the-rise-and-rise-of-private-markets-mckinsey-global-private-markets-review-2018.ashx*

[6] *Id.*

for private fund advisers to register, as in the Proposed Bill, pushes in the opposite direction of encouraging a healthy capital formation environment for private funds, and erodes transparency and prevents important disclosure to investors. Representative David Scott highlighted this in his remarks at the hearing, stating:

> A lot of [these] discussion drafts and bills amount to sort of a drip, drip, erosion of our securities laws, and I'm somewhat worried we may be ignoring the needs of investors and marketplace transparency…a common trend I've noticed in these proposals is there's only one direction we go when we balance investor protections vs. expanding access to capital, and that direction is always [towards] weakening of our disclosure requirements.[7]

II. The Proposal Expands the Venture Exemption Beyond Congress' and the VC Industry's Original Intent

The Proposed Bill would expand the VC exemption beyond that contemplated by Congress, to permit private fund advisers to evade the SEC registration requirement, while holding up to 100% of their portfolio in certain publicly held companies, as opposed to early-stage, privately held businesses. This would fly in the face of the clear purpose of creating the VC exemption when Congress put it in place in 2010. If private fund advisers wish to invest in a greater percentage of publicly held companies, they are free to do so, but they shouldn't be able to pursue these activities outside the VC space while also remaining exempt from SEC registration. Encouraging these activities may also crowd out the ability for retail investors to access EGC IPOs in the public market.

The Dodd Frank Act, when creating the VC exemption, did not impose a limitation on how large or complex the VC adviser could be, unlike the $150 million assets under management (AUM) threshold for SEC registration that applies to most other types of private fund advisers. The SEC followed up the VC exemption with a regulation[8], which this Draft Bill now seeks to amend, which sought to ensure that those who were granted the VC exemption were truly engaged in investing in early-stage, "start-up" businesses. Given the similarity in structure of the funds advised by both VC and PE advisers, it was important that the regulation be tailored to just those with the strategy of investing in these types of earlier stage, privately held companies that Congress wanted to target for greater investment.

The regulation established that those claiming the VC exemption would be permitted to invest 80% of their capital into "qualifying investments"[9], which included various equity securities from "qualifying portfolio company[ies]."[10] This explicitly carved out significant ownership of companies that were public reporting companies, because these companies are not early-stage, start-up businesses, and have sufficient revenue and capital to complete an initial public offering.[11] The

[7] Comments by Representative David Scott (D-GA), at the *"Legislative Proposals to Help Fuel Capital and Growth on Main Street"* hearing in the House Financial Services Subcommittee on Capital Markets, Securities & Investment, on May 23, 2018. *Available via video:* https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=403426

[8] U.S. Securities & Exchange Commission, Final Rule, Release No. IA-3222: *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less than $150 million in Assets Under Management and Foreign Private Advisers*, July 21, 2011. Available at: https://www.sec.gov/rules/final/2011/ia-3222.pdf

[9] 17 CFR 275.203(l)-1.

[10] 17 CFR 275.203(l)-1(c)(3).

[11] 17 CFR 275.203(l)-1(c)(4).

Institutional Limited Partners Association, 1800 M Street NW, Suite 825-S, Washington, D.C. 20036

SEC elected to provide additional flexibility to VC advisers under the exemption, allowing public reporting companies to be held in up to 20% of the portfolio, in order to permit VC advisers to take their companies through an initial public offering and sell them. In the final rule, the SEC explicitly stated:

> Defining a venture capital fund to include funds engaged in some amount of non-qualifying investment activity provides advisers to venture capital funds with greater investment flexibility, *while precluding an adviser relying on the exemption from altering the character of the fund's investments to such extent that the fund could no longer be viewed as a venture capital fund within the intended scope of the exemption*. To the extent an adviser uses the basket to invest in some non-qualifying investments, it will have less room to invest in others, but the choice is left to the adviser.[12]

While the SEC provided a safe harbor of 20% of the portfolio for non-qualifying investments, the VC industry association affirmatively stated to the SEC at the time the rule was proposed that a 15% non-qualifying investment would be sufficient for their investment needs, while highlighting that the proposed rules were "generally consistent with existing venture capital industry practice."[13] The VC industry association further noted that "[b]y keeping this allowance at a low level in comparison with a [VC fund's] overall operations and reasonably applied, this flexibility will allow innovation and job creation to flourish within the venture capital industry without a corresponding risk to [a VC fund's] investors or the financial markets."[14]

To conclude, the SEC deliberately designed the 20% limitation, with support from the VC industry, to ensure that those private fund advisers that elected the VC Exemption would not be investing in significant numbers of later stage, public reporting companies.

III. <u>Expanding the VC Exemption Erodes Investor Protections without Encouraging Additional Capital Formation</u>

The Proposed Bill seeks to erode the investor protections of SEC registration of private funds, in a misguided effort to seek additional capital for investment in EGCs. However, EGCs often already receive significant investment dollars and do not need this extra pool of capital, at the expense of investor protections. As Representative David Scott indicated at the hearing on the Proposed Bill, many recent IPOs have been oversubscribed:

> Let me call your attention to the discussion draft that has to do with requiring the SEC to revise the definition of a qualifying portfolio company to include emerging growth companies, and I couldn't help but think, is this really necessary? My staff tells me that in February 2017, the social media company Snapchat filed for an initial public offering claiming EGC status and was pretty sure the IPO was oversubscribed, with many investors clamouring to buy up its shares, now the

[12] U.S. Securities & Exchange Commission, Final Rule, Release No. IA-3222 at 15-16.
[13] Letter from the National Venture Capital Association to SEC Re: Release No. IA-3111, File No. S7-37-10, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management and Foreign Private Advisers (the Proposed Rules), January 31, 2011, *available at:* https://www.sec.gov/comments/s7-37-10/s73710-14.pdf
[14] *Id.* at 3.

same thing happened in March with Dropbox, when they went public in an oversubscrib[ed] offering claiming EGC status.[15]

Similarly, the Treasury Department under this Administration, in accordance with Executive Order 13772, recently considered whether changes to the Advisers Act registration requirements, including the VC exemption would encourage capital formation. The Executive Order specifically asked the Treasury to "foster economic growth and vibrant financial markets" and to "make regulation efficient effective and appropriately tailored" with the report focusing on the Asset Management industry, including VC and PE advisers."[16] The Treasury report, after considering these issues and in particular the benefit to capital formation, made no recommendations to change the status quo in regard to the current VC exemption or SEC registration for private funds generally. This is important to note in the context of the Proposed Bill, which seeks to limit investor protection (i.e. the application of SEC registration) without delivering any real significant benefit to capital formation in comparison.

IV. <u>SEC Registration Enhances LP Confidence in Investing in US Private Markets</u>

Since it was put into place in 2012, SEC registration has dramatically improved transparency, disclosure and LPA compliance in the private fund asset class due to the regulations and oversight exercised by the Commission. Contrary to the predictions of some in the industry, the SEC registration requirement has encouraged capital formation, with total assets under management and fundraising at all-time highs in the industry. In fact, Preqin, a private fund data provider, stated that 2017 was the best fundraising year in the history of the PE industry, with over $453 billion raised, and the fifth year in a row that PE fundraising has exceeded $300 billion.[17] We believe this is in part because SEC registration has led to improved confidence among LPs to invest in US private funds.

Soon after SEC registration of private equity funds was implemented, there was an effort to remove this important oversight. However, because of significant issues uncovered by the SEC in their examinations, it became clear that this oversight was needed to ensure that these advisers were complying with the terms of the agreements with their investors. In 2014, the SEC highlighted a number of issues that had gone unidentified or unchecked in the absence of regulatory oversight, finding in their initial private equity fund adviser examinations of fees and expenses charged that there were violations of law or *material weaknesses in controls over 50% of the time.*[18] Eroding the registration requirement by expanding the VC exemption in the Proposed Bill would undermine the deterrence of such activities, particularly since the VC exemption does not require VC advisers to be periodically examined by the SEC.

In sum, we encourage you to reconsider moving forward on this legislation and to continue to ensure that the current SEC registration requirement for private fund advisers is maintained, due to the powerful capital formation and important investor protection it delivers.

---

[15] Comments by Representative David Scott (D-GA), at the *"Legislative Proposals to Help Fuel Capital and Growth on Main Street"* hearing in the House Financial Services Subcommittee on Capital Markets, Securities & Investment, on May 23, 2018. *Available via video:* https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=403426

[16] U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities, Asset Management & Insurance,* October 2017, *at* 3, *available at:* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf

[17] Christopher Elvin, *Private Equity in 2018,* Preqin Global Private Equity Report 2018 at 7, *available at:* http://docs.preqin.com/reports/2018-Preqin-Global-Private-Equity-Report-Sample-Pages.pdf

[18] Andrew Bowden, Director, OCIE, U.S. Securities & Exchange Commission, *Spreading Sunshine in Private Equity,* Private Fund Compliance Forum 2014, New York, May 6, 2014, *available at:* https://www.sec.gov/news/speech/2014--spch05062014ab.html

Sincerely,

Steve Nelson
Chief Executive Officer
Institutional Limited Partners Association (ILPA)