GUNDERSON DETTMER

July 8, 2011

VIA EMAIL

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

Re: Release No. IA-3198, File No. S7-17-11, Investment Adviser Performance Compensation (the "Proposed Rule")

Dear Ms. Murphy:

We are pleased to have the opportunity to submit this comment letter in response to the request for comments to the Proposed Rule concerning the adjustment to the dollar amount test under the Investment Advisers Act of 1940 (the "***Advisers Act***") that permits investment advisers to charge performance based compensation to "qualified clients." We greatly appreciate the occasion to provide the Securities and Exchange Commission ("***SEC***" or the "***Commission***") with these comments, which focus primarily on the proposed transition rules as well as the proposed exclusion of the value of a primary residence from the net worth determination.

The Proposed Rule would replace the current transition rules section of rule 205-3 with two new subsections to allow an investment adviser and its clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, even if such performance fees would not be permissible if the contract were entered into at a later date.

While we appreciate this common-sense approach to those advisers subject to transition, we believe that the rule needs to be expanded to address certain foreseeable concerns in the private equity and venture capital industries.

Transfers of Interests.

Within the venture capital and private equity industries, it is common to establish private funds ("***Partnerships***") to which investors (the "***Limited Partners***") are admitted.[1] Such Partnerships are often established with 10-year terms, during which redemptions are generally not permitted. Limited Partners

[1] As the footnote 38 of the Proposed Rule indicates, equity owners of a private investment company are considered to be the clients of the adviser for purposes of rule 205-3(a).

1200 Seaport Boulevard, Redwood City California 94063 Phone 650.321.2400 Fax 650.321.2800

are largely required to hold their investment for an indefinite period of time, and transfers of interests are permitted only in limited circumstances, and usually only with the prior consent of the Partnership's general partner.

From time to time, however, a particular Limited Partner may be required to transfer all or a portion of its interest in a Partnership. This is generally due to unforeseen events or unexpected circumstances, such as the death or divorce of a Limited Partner who is a natural person or the merger or reorganization of a Limited Partner that is an entity. In such cases, the underlying rationale for the transfer rests with the Limited Partner, and not the adviser.[2]

In these limited circumstances, an adviser should not be penalized by losing an existing performance compensation arrangement for decisions and actions beyond the adviser's control.[3] Instead, when a person becomes party to an existing advisory contract as a result of such a transfer of interest initiated by the transferring Limited Partner, the substitute Limited Partner (the transferee) should be deemed to have stepped into the shoes of the transferor. Consequently, we believe that the transferee should remain subject to all conditions of the pre-existing advisory contract, to include any existing performance compensation arrangement.

<u>Involuntary Transfers and Rule 3c-6</u>.

At a minimum, we believe that the category of "involuntary" transfers should be considered when determining whether section 205(a)(1) of the Advisers Act will apply. In 1997, the SEC addressed concerns related to the class of involuntary transfers (death, divorce, gift) in its adoption of rule 3c-6 of the Investment Company Act of 1940 (the "***Company Act***").

Rule 3c-6 of the Company Act speaks to various circumstances where certain transfers of interests in a *Section 3(c)(1) Company* or a *Section 3(c)(7) Company* will not be deemed to cause such a company to lose its exception from being deemed an investment company. Specifically, rule 3c-6 provides that if beneficial ownership of a company is acquired as a result of gift or bequest or pursuant to an agreement relating to legal separation or divorce, then such beneficial ownership shall be deemed to be beneficial ownership by the person from whom the transfer was made (for a Section 3(c)(1) Company) or the transferee will be deemed to be a qualified purchaser (for a Section 3(c)(7) Company).

For public policy reasons, the SEC should not penalize an adviser due to a transfer as a result of death, divorce or bona fide gift. Doing so could result in a significant chilling effect on gifting and be impracticable in the context of death and divorce. Instead, similar carve-outs as are found in rule 3c-6 of the Company Act should be incorporated in the transition rules section of rule 205-3.

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[2] We note that in these cases, legal title to an existing security is being transferred to the transferee, rather than the Partnership issuing a new interest to a new investor. To the extent such a transfer does not constitute an issuance of a new interest by the Partnership, we do not believe that the adviser to a private fund should be required to change its existing compensation structure for the substitute Limited Partner.

[3] In addition to the inherent unfairness in punishing an adviser when a transferor elects or is forced to transfer its interest in a Partnership, there are practical limitations in applying the Proposed Rule to the typical venture capital or private equity structure. In certain cases the Partnership's limited partnership agreement or other governing agreements may not permit Limited Partners to have different economic arrangements.

Exclusion of the Value of Primary Residence from Net Worth Determination.

The SEC proposes to amend the net worth standard in rule 205-3, in the definition of "qualified client," to exclude the value of a natural person's primary residence and debt secured by the property. We request that the SEC consider whether such an amendment is actually warranted.

As noted in the Release, such an amendment is not required by the Dodd-Frank Act. Furthermore, implementing such an amendment would not have the desired effect of protecting individual investors "from performance fee arrangements." Instead, potential investors in a venture capital or private equity private fund who are not qualified clients would simply be excluded from participating in such investments. As evidenced by the comment letters submitted by individuals to the SEC to date, the investing public does not appear to be terribly pleased with such a paternalistic approach.

In defending this proposed amendment, the Release posits that the "value of a person's residence may have little relevance to an individual's financial experience..." Without necessarily disagreeing with this statement,[4] it should be noted that other forms of net worth (e.g., a stamp collection, a priceless Picasso, cash obtained from an inheritance or a lucky lottery ticket) similarly bear little relevance to an individual's financial experience.

Net worth has always served as a rough proxy for financial experience or sophistication (or, at a minimum, the ability to hire professionals who have such requisite experience to properly protect the investor). We are concerned that the proposed exclusion of certain types of assets from the definition of net worth now creates a slippery slope in which the SEC will be in an indefensible position of trying to justify which personal assets bear material relevance to an individual's net worth. Furthermore, if "financial experience" is the touchstone, then we request that the Commission consider adding further relevant factors to the "qualified client" definition, such as a person's advanced education, annual salary or years of employment in a financial industry.

Conclusion.

We request that the Commission carefully consider these concerns and incorporate these comments as part of the transition rules section of rule 205-3. Transfers of interests in an existing, grandfathered private equity fund do not present the same level of concern as a new investor being issued a new interest by the private fund. In the former case, the transferee is merely "stepping into the shoes" of the transferor. We believe that the existing contractual relationship (to include any performance compensation arrangement) between the transferor and the Partnership should continue to apply with respect to the transferee's interest in the Partnership. At a minimum, we encourage the Commission to consider including in rule 205-3 a similar carve-out for "involuntary transfers" as is provided by rule 3c-6 of the Company Act.

[4] It may be argued that in certain parts of the country, where the cost of residential real estate is considerably above the national norm (e.g., Boston, New York, Silicon Valley) and where the amount of capital actually paid by a homeowner as a down payment to acquire a primary residence represents a majority of the person's net worth, the exclusion of such equity from the equation somehow deems a similarly situated apartment renter to have greater "financial experience," even if his equivalent amount of net worth is primarily stashed in a savings account.

Likewise, we hope that the Commission will reconsider the proposal to exclude the value of a person's primary residence from the net worth determination.

We thank the SEC very much for the opportunity to comment on this important matter. If the Commission has any questions concerning these comments, or if we may be of further assistance in connection with this matter, please do not hesitate to contact us.

Very truly yours,

Sean Caplice