GUNDERSON DETTMER

March 8, 2007

VIA EMAIL

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
rule-comments@sec.gov
Attn: Nancy M. Morris, Secretary

Re: Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles (File Number S7-25-06)

Ladies and Gentlemen:

This letter is submitted in response to the request for comments from the Securities and Exchange Commission (the "Commission") on its proposed rules under the Investment Advisers Act of 1940 (the "Advisers Act") and the Securities Act of 1933 (the "Securities Act") to adopt a new antifraud rule under the Advisers Act and to adopt a rule that would revise the requirements for determining whether an individual is eligible to invest in certain pooled investment vehicles (collectively, the "Proposed Rules").

We appreciate the opportunity to comment on the Proposed Rules, and look forward to working with the Commission and its staff as the comments are reviewed. While we understand the Commission's mandate of protecting investors, we respectfully request that the Commission fully consider the concerns raised in this response letter. We are most concerned about the Commission's unfamiliarity with the structure and operations of venture capital firms, and the corresponding flaws in the Proposed Rules.

By way of background, this firm serves as outside counsel to over 125 venture capital firms. We have been recognized as a national and international leader in the representation of venture capital firms, and our client base represents some of the most active, influential and highly respected venture capital firms in the industry. Most importantly, for purposes of this response letter, we advise venture capital funds with respect to their structure, formation and organization so as to ensure their compliance with applicable law. As such, we possess an expertise for the manner in which venture capital funds must be structured so as to operate properly. It is out belief that the Proposed Rules do not properly distinguish a *bona fide* venture capital fund from other private investments vehicles.

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Amendments to Private Offering Rules Under the Securities Act

We agree with the Commission that application of proposed Rule 509 specifically does not, and should not, apply to the offer and sale of securities issued by venture capital funds. However, proposed Rule 509(b)(2) defines a "venture capital fund" to have the same meaning as the definition of a business development company in Section 202(a)(22) of the Advisers Act. As discussed below, the structure, management, investment purpose and operations of a business development company are so dissimilar to that of a *bona fide* venture capital fund that any definition based on such a reference is essentially meaningless. We ask that the Commission not only replace the requirement that a "venture capital fund" have the same meaning as a "business development company" with the "redemption" standard from Rule 203(b)(3)-1(d)(2) of the Advisers Act, but also provide additional elements in such definition as described below.

Business Development Companies

Venture capital funds are not business development companies. The requirements under Section 202(a)(22) of the Advisers Act are such that we are not aware of a single venture capital fund that would ever consider electing to be a business development company ("BDC"). The following items highlight some of the principal differences between a *bona fide* venture capital fund and an entity that has elected to be treated as a BDC:

- *Registration of Securities.* To be a BDC, an entity must have a class of its securities registered under Section 12 of the Securities Exchange Act of 1934 (or have filed a registration statement thereunder).[1] Venture capital funds are privately held investment vehicles that do not register their securities with the Commission.

- *Limitation on Carried Interest.* Pursuant to the Advisers Act, the "carried interest" or "incentive fee" in a BDC may not exceed 20%.[2] Although a 20% carried interest is common for venture capital funds, it is not unusual for the general partner of a top-tier venture capital fund to command a 25% or 30% carried interest.

- *Management.* A majority of a BDC's directors or general partners must be non-interested persons.[3] Venture capital firms do not engage independent managers or directors. Instead, investors in a venture capital fund rely wholly on the expertise and investment acumen of the venture capitalists who founded such venture capital firm.

- *No offshore funds.* A BDC must be organized under the laws of, and have their principal place of business in, the United States.[4] Given the global nature of

[1] Section 54 of the Investment Company Act of 1940.
[2] Section 205(a)(3) of the Advisers Act.
[3] Section 56(a) of the Investment Company Act of 1940.
[4] Section 2(a)(48(A) of the Investment Company Act of 1940.

venture capital investing, many venture capital firms elect to raise one or more of their funds under the laws of a non-US jurisdiction.

• *Registration as an Investment Adviser.* To the extent a person actually serves as an investment adviser to a venture capital fund, such person will almost certainly rely on the exemption from registration provided by Section 203(b)(3) of the Advisers Act. However, the Section 203(b)(3) exemption is not available to any investment adviser who acts as an investment adviser to a company that has elected to be treated as a BDC. ***Consequently, requiring a venture capital fund to elect to be treated as a BDC would require the venture capital fund's adviser (to the extent it has an investment adviser) to register with the Commission as an investment adviser***.

Redemption of Interests

In 2004, the Commission adopted rules related to the registration under the Advisers Act of certain hedge fund advisers (Release No. IA-2333). Specifically, Rule 203(b)(3)-1(d) attempted to differentiate a hedge fund (referred to as a "private fund" in such rule) from other private equity vehicles based on a number of characteristics. The principal characteristic focused on the ability of a fund's beneficial owners to voluntarily redeem any portion of their ownership interests within two years of purchase of such interests.[5]

We believe that such a distinguishing characteristic remains an appropriate measure to determine whether a private investment vehicle is a "venture capital fund" for purposes of proposed Rule 509. Because the limitation on redemptions within two years in Rule 203(b)(3)-1(d) included an appropriate exception for redemptions in the event of extraordinary events, we consider the "redemption characteristic" to be an appropriate factor in defining a "venture capital fund" under proposed Rule 509(b)(2).

Our support for use of a two-year redemption period is conditioned on the understanding that an "extraordinary event" that would permit such a redemption would include the right of a particular investor to withdraw from a fund should such investor's continued ownership cause it to be in violation of any applicable law or policy or otherwise subject such investor to penalties or additional taxes. For example, private pensions funds that are subject to ERISA, government retirement systems and private foundations are typical investors who must be permitted to withdraw under such circumstances. Similarly, investors that are bank holding companies, financial holding companies or subject to the Communications Act of 1934 may require similar withdrawal rights. In addition, we assume that certain customary contractual rights in the governing agreement of a venture capital fund would not be deemed a "redemption right." For instance, such agreements may contain a highly-negotiated right that permits the investors (by a super-majority vote) to dissolve the fund before its stated term. Similarly, the right to receive certain mandatory distributions from a venture capital fund (e.g., to pay tax liabilities within a fiscal year) would not be viewed as a partial "redemption" for purposes of the Proposed Rules.

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[5] Subpart (d)(1)(ii) of Rule 203(b)(3)-1 of the Advisers Act. We note that portions of Rule 203(b)(3)-1 are moot in light of the fact that Rule 203(b)(3)-2 was vacated and remanded in *Goldstein v. SEC*, No. 04-1434 (D,C. Cir. June 23, 2006).

Further, we understand the Commission's concerns regarding the use of a two-year period regarding an investor's redemption rights. We believe that venture capital funds are structured in such a manner that a three-year period, a four-year period or even a five-year period would not materially impact the operations of a venture capital fund. Absent an extraordinary event, the investors in a venture capital fund do not have the right to redeem their interests in the same manner that investors in a hedge fund may do so.

Other Differentiating Characteristics of a Venture Capital Fund

In addition to encouraging the Commission to implement the "redemption characteristic" discussed above into proposed Rule 509(b)(2), we ask that the Commission consider the inclusion of one or more additional non-exclusive factors on which a private investment vehicle may rely so as to be deemed a "venture capital fund." Precisely because the underlying assets and investment objectives of a *bona fide* venture capital fund differentiate it from that of other private investment vehicles which may warrant Commission oversight, we believe that these exceptions for venture capital funds should be considered:

- *Registration of Securities.* The ability of an investor to redeem its interests in a private investment vehicle is predicated on the liquidity of such fund's underlying portfolio. Hedge funds customarily permit periodic redemption not only because their investors so demand this right, but also because hedge funds invest in generally marketable assets that permit such liquidity. To satisfy a redemption obligation, a hedge fund's portfolio must be primarily invested in assets that are readily saleable and not subject to excessive temporal restrictions. The investment objectives of a hedge fund are such that this liquidity is possible.

  In addition to focusing solely on redemption, we suggest that proposed Rule 509(b)(2) also include an additional factor based on a private investment vehicle's underlying portfolio. For example, if greater than 50% of a fund's assets consist of restricted securities (as defined in Rule 144(a)(3) of the Securities Act of 1933), real property or other assets for which no established trading market readily exists, such a fund should be considered a "venture capital fund" for purposes of proposed Rule 509, regardless of the ability of its owners to redeem their interests. In each case, calculation of the 50% threshold should be determined according to the fund's cost basis of each asset.

- *Operations involving underlying portfolio investments.* As between a *bona fide* venture capital fund and other private investment vehicles, material differences exist not only in the nature of their underlying portfolios, but also in the relationship between such fund's manager and its underlying portfolio investments. Managers of *bona fide* venture capital funds are actively involved in the general management and operations of their underlying portfolio companies. This represents a key distinction in the operations between venture capital funds and other private investment vehicles.

In 1985, the Department of Labor adopted rules that introduced the concept of a 'venture capital operating company' ("VCOC") so as to identify those private investment vehicles that actually possess, and exercise, management rights relative to their portfolio companies. We strongly encourage the Commission to provide an additional non-exclusive factor in proposed Rule 509(b)(2) such that any entity that qualifies as a VCOC, regardless of the time within which its owners may be able to redeem their interest in such entity, shall be deemed to be a "venture capital fund."

Thank you very much for the opportunity to comment on this important matter. If you have any questions concerning these comments, or if we can be of assistance in connection with this matter, please do not hesitate to contact me at the number indicated above.

Very truly yours,

Sean M. Caplice