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Via e-mail to: rule-comments@sec.gov

U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090
Attention: Elizabeth M. Murphy, Secretary

Reference: S7-37-10 January 25, 2011

Dear Ms. Murphy,

Thank you for the opportunity to provide comments on the SEC's proposed rules relating to exemptions for advisers to certain private funds. I have worked as the controller of several foreign and domestic funds of private equity funds with foreign and U.S. corporate and public pension plans and other qualified investors that were advised by a foreign investment adviser. I hope that my knowledge of industry practices will be relevant in the rulemaking process. I will start with some general comments and later turn to answering the questions that the SEC had in its release.

1. Exemption for venture capital fund advisers

1.1 Define what a venture capital fund does rather than what it does not

In my opinion, the rules are too prescriptive and create unnecessary restrictions for venture capital funds that do not reflect the diversity of the current business practices and structures of existing venture capital funds and do not leave sufficient flexibility for the evolvement of future business practices and structures. The rules may have unintended consequences for some venture capital funds in situations that may not even be fully under the control of funds or under the control of their portfolio companies or compel venture capital funds and their portfolio companies to actions that may not be in the best interest of investors and that may not maximize investment returns.

The SEC's proposed definition primarily uses a negative definition of a venture capital fund that defines what a venture capital fund does not do (i.e. what a venture capital fund *is not*). I understand the Commission's intent to prevent the use of the venture capital exemption by other funds, such as leveraged buyout funds, hedge funds or money market funds. However, as the proverb says, the road to hell is paved with good intentions. In addition, the proposed definition of a venture capital fund also seems to be driven by the perception of the staff of the Commission of business practices that "most" venture capital funds seem to follow. However, venture capital funds follow a variety of practices and have a variety of structures in practice. The legislative history does not suggest that Congress intended to make the exemption contingent on the absence of leverage or on a limitation of the use of leverage by portfolio companies or by the fund itself or that Congress intended to restrict the exemption to a subgroup of venture capital funds with certain most common practices.[1] The Senate

[1] The House Committee on Financial Services chose not to adopt an exemption for private fund advisers with

Committee on Banking, Housing and Urban Affairs only mentions that venture capital funds *generally* rely on equity funding, so that losses that may occur do not ripple throughout world markets, but are borne by fund investors alone.[2]

The SEC should use a positive definition of a venture capital fund that defines what a venture capital fund does (i.e. what a venture capital fund *is*). The Senate Committee on Banking, Housing and Urban Affairs also uses a positive description of what venture capital funds do, rather than defining what they do not do. The committee describes venture capital funds as a subset private investment funds, specializing in long-term equity investment in small or start-up businesses.[3] Such a positive definition should be restricted to a few essential principles and should avoid outright restrictions or bright line percentage thresholds in order to avoid unintended consequences and to allow business practices to evolve in the future. The main characteristic of a venture capital fund is that it *primarily* provides risk capital (i.e. venture capital) to young businesses that are not able to obtain the needed capital from banks or from the public capital market.

1.1.1 Nature of a portfolio company at the time of initial investment

A venture capital fund's *initial investment* in any long-term financial asset has to be an investment in a young business that has not had positive cumulative earnings before interest, taxes, depreciation and amortization (EBITDA) since the inception of the business. An alternative, but more restrictive condition would be to require that the initial investment in each business needs to be in a young business that has not had positive EBITDA *in any financial year* since the inception of the business. The lookback to the inception of the business should look through any changes in the legal form of the business (i.e. the inception of the business rather than the establishment or incorporation of its legal form). EBITDA is used as a financial ratio by banks and investment analysts to assess the capacity of a business to incur and pay back debt or to generate value for providers of equity capital. The absence of positive EBITDA prevents a young business to obtain significant amounts of capital from banks or from the public capital market.

1.1.2 Purchase of securities from other shareholders

Venture capital funds should not be required to only purchase securities from the portfolio company so that all of the capital is received by the company when making initial investments or follow-on investments. In addition, the portfolio company should be able to use the proceeds to redeem securities or to repay loans.

Venture capital funds should be able to purchase securities from other shareholders so that a part of the capital is received by the former shareholder. Venture capital funds may want to acquire the majority of the shares or a large stake of the shares in order to have the ability to

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less than 500 million dollars of assets under management that do not have systemic risk characteristics to be defined by the SEC, but rather chose an exemption for private funds advisers with less than 150 million dollars of assets under management without requiring the absence of characteristics that might be relevant for systemic risk, such as the use of certain amounts of leverage. See proposed and ultimately withdrawn amendment by Congressman Peters and the debate on this amendment between 50:10 and 01:18:19 (cf. http://financialservices.house.gov/media/file/markups/111/peters_609.028.pdf and http://financialserv.edgeboss.net/wmedia/financialserv/markup102709.wvx).

[2] Cf. U.S. Senate Comittee on Banking Housing and Urban Affairs, Report No. 111-176, analysis of section 407 on page 74

[3] Cf. U.S. Senate Comittee on Banking Housing and Urban Affairs, Report No. 111-176, analysis of section 407 on page 74

later force the minority shareholders to sell 100% of the shares to an interested buyer. In addition, the existing shareholders may want to sell a part of their shares because they need liquidity for private reasons. Furthermore, a venture capital fund that has reached the end of the contractual life of the fund may want to sell all of its shares to another venture capital fund.

The requirements that a portfolio company needs to have cumulative negative EBITDA since inception at the time of initial investment will naturally ensure that the venture capital fund will have to provide venture capital to the portfolio company to finance its operating expenses and does not just provide capital to existing shareholders.

1.1.3 Offering of management assistance to portfolio companies

Venture capital funds should not be required to offer management assistance to portfolio companies or to own a controlling majority of the shares of their portfolio companies.

The core feature of a venture capital fund is the provision of venture capital to young businesses. Whether the venture capital fund owns a majority stake or just a small stake in the young business, whether it holds a seat on the board of directors, is an observer at the board or is not represented at the board at all and whether it offers management assistance to the company is not important and is purely incidental to providing risk capital. The SEC should keep in mind that often several venture capital funds invest together in a portfolio company and may only hold small minority stakes.

1.1.4. Age of a portfolio company at the time of initial investment

A maximum age of the business at the time of initial investment is not really necessary. The negative EBITDA requirement will guarantee that risk capital is invested in a business that has never been profitable on a cumulative basis since its inception. This requirement would eliminate most investments in businesses that have previously been profitable and that have started to make losses afterwards (i.e. special situations funds). If the SEC nevertheless wants to impose a maximum age at the time of initial investment as an additional condition, it should opt for a very high number of years to allow the continued provision of venture capital over a long time to businesses that require many years of development effort until they generate a product (e.g. drug development). This would ensure that venture capital funds that have reached the end of their fund life or that run out of capital can sell young businesses that still need venture capital to other venture capital funds in secondary transactions.

1.1.5. Maximum holding period of a portfolio company after the initial investment

Venture capital funds should be required to liquidate their investments in a young business after a maximum amount of years after their initial investment (i.e. a mandatory maximum holding period). Liquidations can take many forms, such as sales, or taking the portfolio company public and distributing shares in the public company to the fund’s investors as a distribution in kind. This second principle ensures that a venture capital fund does not slowly transform itself into a fund that holds mature profitable companies over time (i.e. that venture capital funds do not transform into private equity funds or growth capital funds). The limited life clause in limited life fund contracts indirectly forces funds to sell their portfolio companies and to return the proceeds from the sale to investors before the fund needs to be dissolved at the end of its life. In the case of venture capital funds with a limited life that are required to distribute the proceeds from the liquidation of portfolio companies to the investors and the fund manager/investment adviser, the SEC could only require a maximum life of the fund rather than requiring a maximum holding period for its portfolio companies in order to provide more flexibility and to avoid unintended consequences.

However, some evergreen venture capital funds with an infinite life do not contain a clause that forces them to liquidate their portfolio companies after some time and to distribute the proceeds to investors or to reinvest them in new portfolio companies. As a consequence, a rule that specifies a maximum holding period for portfolio companies would ensure that an evergreen venture capital fund stays a venture capital fund and does not transform itself into a private equity fund or a growth capital fund over time. The commission should note that its current proposed negative definition of a venture capital fund would allow growth capital (expansion capital) funds to use the venture capital fund exemption because they typically to not finance a part of the purchase price through additional debt at the portfolio company level and provided that they do not buyout the existing shareholders and stick to minority stakes. However, growth capital (expansion capital) funds are generally not considered to be venture capital funds because they provide risk capital to businesses that already generate profits (just not enough profits to finance their need for growth capital internally or through debt financing).

Rules that require a minimum percentage of the total investments to be in portfolio companies that have negative EBITDA or that limit the maximum percentage that can be invested afterwards through follow-on investments are not necessary. A maximum holding period will ensure that a portfolio company cannot stay long in the growth capital (expansion capital) phase, but will allow the fund the flexibility to choose the best time for the sale in order to maximize the return for its investors (to prevent harming investors).

Most limited life venture capital or private equity funds have a term of 10 years that can be extended twice by one more year by a (qualified) majority of investors. Typically initial investments in new portfolio companies are only allowed during the first five years (the investment period). The remaining years are reserved for follow-on investments in existing portfolio companies and for the sale of the portfolio companies). As a consequence, I recommend a maximum holding of twelve years from the time of initial investment until the full liquidation of the investment.

1.1.6. Investments in public companies

Venture capital funds should be allowed to invest in public companies without any restriction. The fact that a company is listed on a stock exchange, that it has 500 or more shareholders or that its securities have been offered to the public does not automatically mean that it will be able to obtain further capital that it needs from the public capital market or from banks.

There are several examples of biotech companies that are listed on the Zurich stock exchange that have not generated positive EBITDA since inception. Such companies need further venture capital to finance their research operations until they have patents and can generate sufficient revenues from those products. The fact that a young business is private or public does not change the fact that it might still have negative EBITDA and that it might not be able to obtain financing from other sources and thus still need venture capital.

The definition of the term publicly traded in the proposed rule 275.203(l)-1(c)(3) is not consistent as far as the use of a public capital market of a foreign jurisdiction is concerned. Being subject to the reporting obligations of section 13 or 15(d) of the Securities Exchange Act of 1934, covers portfolio companies whose securities are listed on a national securities exchange in the U.S., whose equity securities are widely held and traded over-the-counter in the U.S. or whose securities have been publicly offered in the U.S. However, the term listed or traded on any exchange or organized market operating in a foreign jurisdiction only seems to be the foreign equivalent of a registration under section 12(b). In order to be consistent, the rule would also need to cover securities that have been publicly offered to investors in a foreign jurisdiction and equity securities that are widely held and traded over-the-counter in a foreign jurisdiction. I recommend to use the term securities exchange rather than exchange and to remove the references relating to trading and to an organized market if language relating to over-the-counter trading is included.

1.1.7. Investments in debt securities issued by portfolio companies

Venture capital funds should be allowed to invest in equity or debt securities that are issued by portfolio companies. They should also be able to provide loans or credit lines to portfolio companies regardless of whether those would be treated as securities by U.S. securities law.

Venture capital is risk capital. Risk capital that is provided to portfolio companies that do not generate positive EBITDA is risky even if it is provided in the form of debt.

Venture capital funds may choose to invest in the form of debt in portfolio companies for a variety of reasons. They may want to provide bridge loans to portfolio companies until they have completed the paper work for a capital increase to create additional shares. They may want to provide short-term liquidity to the portfolio company without diluting the ownership stake of the other shareholders or because they want the extra security of debt when injecting more capital that other investors are not willing to inject. Depending on the jurisdiction, it may be more favorable for tax reasons because interest expenses lower the base for income tax. It may also be more favorable for bankruptcy reasons if the bankruptcy law would treat the investment as debt so that not all of the capital that was provided by the venture capital fund is satisfied last in the liquidation. In some jurisdictions, it may not be possible to create redeemable preferred shares. In addition, the procedures for a formal capital reduction or for repurchases of shares from investors by the portfolio company may be overly restrictive, time consuming and burdensome. In such a case the fund may want to structure a part its investment in the form of debt that can be repaid more easily.

1.1.8. Limits on the use of debt by portfolio companies

The absence of positive EBITDA will naturally prevent a portfolio company to obtain significant amounts of debt financing. As a consequence, limits on the use of debt by portfolio companies at the time of the initial investment by the venture capital fund and while the investment is being held by the fund *are not necessary*. The maximum fund life or a maximum holding period for investments in portfolio companies will naturally limit the time period during which portfolio companies with significant amounts of debt will be held by venture capital funds.

Limits on the use of debt by portfolio companies that are owned by venture capital funds have negative consequences for the young businesses and for the investors in venture capital funds. Young businesses may be able and should be able to obtain a limited amount of debt financing that can be secured by the fixed assets of the business or by the private assets of owners. Prohibiting venture capital funds to invest in young businesses that have existing debt could prevent young businesses from obtaining capital from venture capital funds. In addition, young businesses should be able to obtain debt financing if they manage to create intangible fixed assets (e.g. patents) or to start making positive EBITDA after the initial investment. The ability to use debt financing provides an opportunity to achieve a higher investment returns on the capital provided by the investors of the venture capital fund and to maximize the growth opportunities for the young business.

1.1.9. Limits on investments in cash and cash equivalents

A venture capital fund may not hold more than 5 per cent of the total assets on its balance sheet in cash, cash equivalents, money market funds or debt securities that were not issued or guaranteed by portfolio companies or subsidiaries of portfolio companies for more than 90 days. Any definition should not be limited to U.S. treasuries because U.S. or foreign venture capital funds may want to invest in short-term securities issued by states or municipalities or by foreign countries or their subdivisions.

The main purpose of this prohibition is to prevent money market funds from holding themselves out as venture capital funds. However, the ability to even hold significant amounts of cash on a temporary basis is important for ensuring smooth operations at venture capital funds. Since investors analyze the internal rate of return (IRR) to investors of previous venture capital funds that were managed by the same adviser before they invest in a successor fund, fund managers have an incentive not to hold cash for extended periods of time in order to maximize the IRR.

Calling investors to contribute a part of the capital that they committed to the fund takes some time. As a consequence, some venture capital funds call capital from investors in advance of investing this capital in portfolio companies. In addition, there may be delays in the process to close the purchase of a portfolio company. The proposed limit would allow a newly established fund to initially hold even 100% of the total assets on its balance sheets in cash for less than 90 days until they can be invested in a portfolio company.

In addition, organizing a distribution of capital to investors also takes time and in the case of several imminent sales of portfolio companies during one quarter, a fund may opt to wait until a further sale and to make one combined distribution of the proceeds from the sale of several portfolio companies in order to minimize the administrative effort for the fund and for its investors. It would also allow a limited life fund that has sold its last or one of its last portfolio companies to hold the proceeds from the sale in cash for up to 90 days until they are distributed to investors. In such as situation, a fund may hold up to 100% of its total assets in cash.

1.1.10. Other assets than portfolio companies or cash

The definition in the proposed rule 275.203(l)-1(a) of a venture capital fund seems to forget that the total assets on the balance sheet of a venture capital fund typically also contain other assets than equity securities issued by portfolio companies or cash and cash equivalents and U.S. treasuries. As a consequence, a venture capital fund will not be able to fulfil the “owns solely” criterion contained in subsection (a)(2). The balance sheet of a venture capital fund can also contain other assets, such as accrued interest income, accrued income from advisory or management services to portfolio companies unless they are invoiced by the fund manager rather than by the fund, prepaid management fees, receivables for value added tax (VAT) paid to suppliers if the fund can invoice services to portfolio companies that are subject to VAT and can thus reclaim VAT paid to its suppliers and other accruals and receivables that are incidental to the operation of a private fund. The SEC’s venture capital fund exemption should allow venture capital funds to have such operating assets that are the result of accruals or prepayments.

1.1.11. Investments in venture capital funds and intermediate holding companies

There is no indication that Congress intended to restrict the venture capital fund exemption to (direct) venture capital funds and to exclude funds of venture capital funds.

The capital invested by funds of venture capital funds represent a significant percentage of the total amount of capital that is invested in (direct) venture capital funds. For many investors it is not economical to incur the cost for internal investment specialists that are able to perform investment due diligence on venture capital funds. As a consequence, they outsource this task by investing in funds of venture capital funds.

In addition, venture capital funds may invest in portfolio companies through intermediate holding companies that may have a variety of legal forms for various legal and economic reasons. Those investments may be made by the fund alone or together with other venture capital funds or together with investors of the venture capital fund.

The main policy objective behind the venture capital fund exemption is to ensure the provision of venture capital to young businesses. It should not matter through which vehicles the venture capital flows from the investors to the young businesses.

As a consequence, the SEC should allow advisers to funds of venture capital funds to invest in venture capital funds that qualify for the exemption as well as in venture capital portfolio companies.

In addition, the SEC's rules should look through any holding companies to the underlying operating company as far as the eligibility of investments in portfolio companies is concerned.

1.1.12. Limits on the use of debt by venture capital funds

The inability of portfolio companies to generate positive EBITDA will also naturally prevent venture capital funds from incurring significant amounts of debt because they are unable to receive timely distributions of cash from their portfolio companies that can be used to repay debt at the fund level. This naturally restricts debts at the fund level to an amount that can be repaid by calling uncalled committed capital from investors. Thus the credit evaluation procedures of banks will naturally prevent funds to incur excessive debt at the fund level without the need for regulatory limits.

It is common practice that venture capital funds pre-finance initial investments or follow-on investments in portfolio companies through the use of short-term credit lines at the fund level and later repay the credit by calling uncalled committed capital from the funds' investors. The fund agreements typically require venture capital funds to issue capital call notices to their investors several days in advance of the date of the payment of the capital. Sometimes investors pay late. In order to be able to make investments quickly and to reliable have the full amount of investment available on time, venture capital funds need the ability to obtain a limited amount short-term debt financing at the fund level.

If the SEC chooses to impose limits on debt at the fund level, it should *not* express them as a percentage of the fund's total assets, as a percentage of the fund's uncalled capital commitments or as a percentage of the sum of total assets and uncalled capital commitments due to unintended consequences.

A young venture capital fund may want to pre-finance its first investment in a portfolio company through the use of a credit line at the fund level. In this situation the young fund has no or little assets on the balance sheet at the time of investment, but has a high amount of uncalled capital commitments. As a consequence, the amount of debt could easily reach 100% of the total assets on the balance sheet of the fund, but the same amount of debt as a percentage of uncalled capital commitments or as a percentage of the sum of total assets and uncalled capital commitments would be much lower.

A mature venture capital fund may want to pre-finance its first investment in its last new portfolio company through the use of a credit line at the fund level. In this situation the mature fund has no or little assets on the balance sheet at the time of investments because it may have already sold its investments in the other portfolio companies and distributed the proceeds to the fund’s investors. A mature fund will also have a low amount of uncalled capital commitments. As a consequence, the amount of debt could easily reach 100% the total assets on the balance sheet of the fund. The same amount of debt as a percentage of uncalled capital commitments or as a percentage of the sum of total assets and uncalled capital commitments could be lower, but could also reach close to 100%.

In the case of venture capital funds with a limited life that have contractual capital commitments from investors that can be utilized over the life of the fund, limits on the use of debt at the fund level should only be limited to 100% of the uncalled capital commitments. On a first glance, debt could be limited to a percentage of total (i.e. called and uncalled) capital commitments. However, limiting debt as a percentage of total capital commitments may prevent a venture capital fund from temporarily pre-financing an investment in a portfolio company if the minimum diversification provisions in the fund agreement allow the amount of the investment to exceed this percentage of total capital commitments.

In the case of an evergreen fund with an unlimited life and no capital commitments from investors, debt could only be limited to a very low percentage of the total assets on the fund’s balance sheet. Since the illiquid assets of the fund are the only means to repay this debt and since the fund has only a limited ability to choose the timing of the sale of its assets, this could create undesirable risks for the fund’s investors and for the banks that provide the credit.

1.1.13. Limits on the use of commitments and guarantees by venture capital funds

If the SEC chooses to impose limits on the use of debt by venture capital funds, it should also limit the amount of commitments and guarantees that venture capital funds can make.

In the event that the commitments and guarantees become payable, the venture capital fund will need to fund them with capital and may have to resort to taking on debts.

Over-commitments (i.e. committing more capital to underlying funds than the investors committed to the fund of funds) can be an issue at funds of funds. There are fund agreements for funds of private equity funds that impose limits on the amount of debt that the fund may incur, but that do impose limits on the amount of capital that the funds of funds may commit to underlying private equity funds. Some evergreen Swiss funds of private equity funds that are listed on stock exchanges ran into liquidity troubles because they committed more capital to underlying funds than they available in the form of liquid assets. As a consequence, they had to perform forced sales of interests in underlying funds at potentially sub-optimal prices.

The SEC should be mindful that fund managers have an economic incentive to incur leverage at the fund level and to over-commit because it increases the amount of assets they can invest and thus increases the total amount of carried interest they can receive on the total profits from the sale of those assets. However, both leverage at the fund level and over-commitments increase the risk for the investors in the fund. Since fund managers typically only have to invest 1% of the total capital of the fund, but typically receive 20% of the total profits of the fund as carried interest, their upside in increasing the amount of assets that the fund can invest an in taking more risk is much higher than their downside.

1.1.14. Limits on the life time of funds

Venture capital funds are structured in different ways and have different practices. Most venture capital funds have a limited contractual life during which they need to sell all portfolio companies and distribute the proceeds to investors before the funds are dissolved (typically structured as limited partnerships). However, some venture capital funds are structured as evergreen funds with an infinite live and are actively traded by qualified or retail investors and may even be listed on a securities exchange. There is no indication that Congress wanted to exclude evergreen venture capital funds that are not traded on a securities exchange and that are only open to qualified investors.

1.1.15. Limits on rights to redeem fund interests

Limited life funds and evergreen funds usually do not provide investors with a right to redeem their interest in the fund but leave control over the timing of distributions to investors at the discretion of the fund manager due to the illiquid nature of investments in young businesses. A right to redeem interests in a fund that holds illiquid investments could cause undesirable problems by forcing the fund to incur debt on the fund level to pay out the investor or to sell illiquid assets at unfavorable prices in forced sales. In the case of a market panic among investors the fund may even have to temporarily suspend redemptions for all investors.

1.2 Answers to specific questions from the SEC relating to venture capital funds

1.1 Would our proposed approach to follow-on investments accommodate the way venture capital funds typically invest?

In my opinion the proposed approach to follow-on investments is overly restrictive. Venture capital funds should be able to continue to make follow-on investments in a portfolio company after it has been taken public. A venture capital fund may continue to hold significant stakes in a portfolio company for some time after listing the portfolio company on a stock exchange due to lock-up agreements that force it to hold a part of the shares for a longer period or because the market may only be able to absorb sales of tranches of its holdings. Since the economic circumstances and the portfolio company's need for capital may change after the listing, venture capital funds should not be banned to make follow-on investments in listed companies if the need arises. As mentioned previously a maximum holding period since the time of the initial investment is a better approach to ensure that venture capital funds do not transform into funds with holdings in mature profitable companies over time.

1.2 Are there circumstances in which a venture capital fund would provide follow-on investments in a company that has become public?

As mentioned above, venture capital funds may continue to hold investments in portfolio companies for some time after listing those portfolio companies on the stock exchange. Portfolio companies may be in need of capital due to changes in the economic climate. Since not all circumstances can be foreseen, it would not be prudent to prohibit venture capital funds from providing additional capital to their portfolio companies that have gone public if they need capital. The mere fact that a portfolio company is public does not guarantee that it will always be able to obtain equity financing from the public. In addition, venture capital fund may want to stimulate the interest of investors through a listing on a stock exchange in view of a sale in the next few years, but may want to continue to provide expansion capital to further grow the business until the sale.

1.3 Should the rule specifically provide that a venture capital fund includes a fund that invests a limited percentage of its capital in publicly traded securities under certain circumstances (e.g., a follow-on investment in a company in which the fund's previous investments were made when the company was private)?

Venture capital funds should be allowed to make both initial and follow-on investments in public companies. A young business may have been taken public (by the founders or previous owners) and later may not be able to raise enough new capital in the public market, but may have to turn to a venture capital fund to obtain all or a part of the new capital that it needs. There are young pharmaceutical companies that are still in the research phase and that have not been able to generate a profit yet that are nevertheless listed on the Zurich stock exchange. I see no reason why public companies should not be able to get venture capital from venture capital funds. Venture capital is characterized by the fact that it represents risk capital for young businesses with negative EBITDA. Whether such a young business is publicly or privately held does not change its nature and the merits to obtain venture capital.

1.4 If so, what is the appropriate percentage threshold (e.g., 5, 10 or 20 percent)?

There should be no limit. Limits are too prescriptive and inflexible, especially if they are expressed as a percentage of total assets rather than of total committed capital. However, venture capital funds that are not structured as self-liquidating limited life funds do not have a committed capital that they can drawn down from their investors. A venture capital fund may only hold one or a few portfolio companies early in its life or late in its life when it has already sold most of its portfolio companies. In such situations a percentage may even reach 100 per cent. In addition, not all venture capital funds have a limited life and have a committed capital.

1.5 We request comment on whether our definition should exclude any venture capital fund that holds any publicly traded securities or a specified percentage of publicly traded portfolio company securities. What percentage would be appropriate?

The definition should not exclude venture capital funds that hold publicly traded securities and should not specify a maximum percentage of publicly traded portfolio companies. The rules should not distinguish between public and private companies. They should focus on the nature of the company at the time of initial investment (i.e. the absence of positive EBITDA since inception) and on a maximum holding period.

1.6 What percentage would give venture capital funds sufficient flexibility to dispose of their publicly traded securities?

There should not be a maximum percentage. A venture capital fund with a limited life may only hold one listed portfolio company at the end of its life and may thus even hold 100 per cent of its total assets in publicly traded securities. In addition, a venture capital fund may be able to take its first portfolio company public soon without having had a sufficient deal-flow that allowed it to acquire additional portfolio companies.

1.7 Would 30 or 40 percent of the value of a venture capital fund's assets be appropriate?

No. For the reasons specified above, this would not be flexible enough.

1.8 Should the rule specify that publicly traded securities may only be held for a limited period of time, such as one- year, or that a venture capital fund's entire portfolio may not consist only of publicly traded securities except for a limited period of time, such as one-year or other period?

No. A venture capital fund should have the flexibility to continue to provide expansion capital to grow the business and to decide the timing of the sale in order to maximize the return for its investors. However, there should be a maximum holding period since the time of the initial investment in a portfolio company regardless of its public or private status during the holding period.

1.9 Should our definition of venture capital fund include funds that invest in debt, or certain types of debt, issued by qualifying portfolio companies, or make certain types of loans to qualifying portfolio companies?

Yes. The Commision's rules should allow any form of investment in a portfolio company in any form of equity capital or debt capital. A venture capital fund may choose to invest in debt securities or to make loans to a portfolio company in addition to investing in its equity securities for a variety of reasons. For example, investments may initially be made in the form of loans before the necessary company paperwork can be executed to increase the capital of the portfolio company. This will largely depend on state or foreign company law and the company's governing documents. In addition, a venture capital fund may decide to make several loans and only periodically convert them into formal capital in order to save legal and notary fees. Furthermore, a venture capital fund may choose to make investments that take the form of debt with high deferred interest payments (or a pay in kind interest) and an option to convert them into equity or to acquire additional equity. Such investments in debt have the economic character of quasi-equity. They may be made for tax reasons if the interest expense is tax deductible and if the tax losses can be carried forward to reduce the taxable profit in future profitable tax years. They may also serve as a protection in bankruptcy proceedings to allow it to recover at least a part of the remaining assets unless the applicable bankruptcy law qualifies them as equity. They may also serve as a downside protection for the venture capital fund, so that it can receive a minimum amount of return through interest payments first before the portfolio company's management and employees can receive dividends on their shares. The SEC should be mindful that portfolio companies may have been established or organized under the laws of a foreign country or may have their principal places of business in foreign countries and may thus be subject to foreign company laws, bankruptcy laws and tax laws.

1.10 Should our definition include any fund that extends bridge financing that does not meet the definition of "equity security" on a short-term limited basis to a qualifying portfolio company?

Yes. The rules should not distinguish between the provision of equity and debt capital to portfolio companies and should allow any type of debt capital. Bridge financing is one example of the use of investing in debt. However, there should be no time limit for holding investments in debt. This would only serve to reduce the flexibility of venture capital funds. In this case the debt is quasi-equity from an economic perspective and is also venture capital.

1.11 Should our definition be limited to those funds that make bridge loans to a portfolio company that are convertible into equity funding only in the next round of venture capital investing?

No. A maximum amount of flexibility is best. There is no obvious justification for reducing this through regulation.

1.12 Under our proposed definition, debt investments or loans with respect to qualifying portfolio companies that did not meet the definition of "equity security" could not be made by a fund seeking to qualify as a venture capital fund. Should we modify the proposed rule so that such investments and loans could be made subject to a limit?

Yes. What matters is the provision of venture capital, regardless whether it takes the form of equity or debt. However, there should be no limit for providing loans to portfolio companies or for investing in debt securities that are issued by portfolio companies.

1.13 If so, what would be an appropriate limit (e.g., 5 or 10 percent) and how should the limit be determined (e.g., as a percentage of the fund's capital commitments)?

There should be no limit in order to provide a maximum amount of flexibility.

1.14 Should the rule only specify that cash be held in anticipation of investments, or in connection with the payment of expenses or liquidations from underlying portfolio companies?

No. The rule should only prevent using the venture capital exemption for funds that are actually money market or cash funds. I am sceptical whether an intent or purpose test can be effectively monitored and enforced by the Commission.

1.15 Are there other types of cash instruments in which venture capital funds typically invest and/or that should be reflected in the proposed rule?

Investments in money market securities or in funds that invest in the money market securities (i.e. in short term debt securities) should be allowed. There is no reason why investments in government securities should be restricted to U.S. Treasuries. Investments in debt securities that are issued by foreign governments or political subdivisions should also be permitted.

1. 16 Should our proposed definition similarly define a venture capital fund as a fund formed *under the laws of the United States and/or that invests exclusively or primarily in U.S. portfolio companies or a sub-set of such companies (e.g., U.S. companies operating in non-financial sectors)?*

The rules should not exclude investments in companies that operate in certain sectors. They should allow investments in portfolio companies that are incorporated or organized under the laws of any state or of any foreign country. A company may be incorporated in one country and may have all or a part of its operations in another company.

1.17 Are venture capital funds that invest in non-U.S. portfolio companies more or less likely to have financial relationships that may pose systemic risk issues, a rationale that was presented and appeared significant to Congress in exempting advisers to venture capital funds?

No. I do not see why a non-U.S. portfolio company would be more or less likely to have financial relationships that may pose systemic risk issues.

1.18 Should we use a test other than whether the loan is "in connection with" the fund's investments?

Yes. Portfolio companies should generally be allowed to have debt financing. Even young businesses may be able to obtain debt financing if they have assets that can serve as collateral, if debt is guaranteed by private assets of their owners or if debt is in the form of company credit cards. As previously mentioned, the definition of a venture capital fund should focus on providing venture capital to new companies and should not be a negative definition what venture capital funds do not or are not permitted to do. In addition, the definition "in connection with" is too ambiguous. In addition, the "in connection with" test seems unworkable and prone to circumventions. When after the investment in the portfolio company would taking on debt no longer be in connection with the investment? Surely the Commission does not want to prevent portfolio companies that are able to generate positive EBITDA some time after the investment from obtaining debt financing. In addition, a venture capital fund could obtain the debt financing at the fund level or for an acquisition holding company and later push-down the debt to the portfolio company after the investment and after an "in connection with" period.

1.19 For example, should the test be whether the portfolio company currently intends to borrow at the time of the fund's investment?

No. This seems to be unworkable and prone to circumvention. How does the Commission want to prove that a fund lied when it said that it did not intend to borrow at the time of the fund's investment? As the economic circumstances change, a portfolio company may suddenly be able to obtain debt financing or may no longer be able to obtain debt financing.

1.20 Should the test depend only on how the portfolio company uses the proceeds of borrowing, such as by excluding companies that use proceeds to buyout investors or return capital to a fund?

No. Any rules on how the proceeds from borrowing can be used would need to be extremely detailed to prevent circumventions. Portfolio companies should be able to use the proceeds from borrowing how they want. A portfolio companies that starts to generate positive EBITDA and is able to obtain debt financing should be able to return capital to the venture capital fund.

1.21 Should we define a qualifying portfolio company as a company that does not incur certain specified types of borrowing or other forms of leverage?

No. Portfolio companies should be allowed to use all types of financing, including debt financing, that they can obtain. The goal is to get a maximum amount of financing in order to be able create a maximum amount of jobs. As mentioned, young businesses should not have had a positive EBITDA in any financial years since their inception at the time of the initial investment by the venture capital fund. However, they may have been able to obtain debt financing before the initial investment because they had assets that could serve as collateral, through credit cards or because the founders may guarantee for company debts with their private assets.

1.22 Would such a definition narrow the current range of portfolio companies in which venture capital funds typically invest?

Yes. As I previously mentioned, some venture capital portfolio companies are able to obtain a limited amount of debt.

1.23 Is our assumption that venture capital funds do not generally acquire portfolio company securities directly from existing shareholders correct?

No. Venture capital fund should be allowed to buy securities directly from existing shareholders. Many venture capital funds prefer to hold a majority of the equity securities with voting rights in order to have control over the portfolio company, especially to have control to be able to sell the portfolio company to finally generate liquidity for their investors. Some venture capital funds may only hold a minority of the voting rights, but may have a majority through shareholder agreements with other investors or have rights that allow them to drag-along other investors in a sale or that allow them to tag-along with other investors in a sale. The governing documents of many venture capital funds provide that the funds have a limited life and are dissolved at the end of their life. As a consequence, those venture capital funds need to be able to enforce the sale of their portfolio companies in order to adhere to their governing documents.

1.24 Is 80 percent the appropriate threshold?

No. There may be cases where a young business unexpectedly is able to generate positive EBITDA shortly after the venture capital fund has bought equity securities from the previous shareholders and thus no longer requires additional capital from the fund.

1.25 Should the threshold be set lower?

There should be no threshold at all. The condition that a certain percentage of securities need to be acquired directly from the portfolio company should be dropped.

1.26 Should direct acquisitions of equity securities be increased to 90 percent or 100 percent in order to more effectively prevent advisers to funds engaged in activities that are not characteristic of venture capital funds from relying on the exemption?

No. A positive definition of a venture capital portfolio company will ensure that venture capital funds primarily provide venture capital and some development capital.

1.27 Does the definition's focus on a portfolio company's use of capital received from a venture capital fund impose any unnecessary burdens on the company's operation or business?

Yes. I believe that regulations of the use of capital received from a venture capital fund are unnecessary and reduce the flexibility of the fund and its portfolio companies.

1.28 Rather than define a venture capital fund by reference to the manner in which it acquires equity securities (or the manner in which qualifying portfolio companies may indirectly facilitate a buyout), should the proposed rule instead define the manner in which proceeds from a venture *capital investment may be used?*

No. The Commission should not regulate from whom the securities can be acquired or how the capital can be used.

1.29 For example, should the rule specify that proceeds of borrowings or other financings not be used to finance the acquisition of equity securities by a venture capital fund or otherwise distribute company assets to equity owners?

No. As mentioned there are legitimate reasons why a venture capital fund may want to acquire securities from the previous owners. Having control over the portfolio company is vital for the protection of the fund's investors because the fund needs to be able to force a sale of its investment and even to drag-along other investors because potential buyers prefer to buy all shares or at least control-stakes. In addition, control over portfolio companies helps to monitor how the capital is being spent by the portfolio companies and allows the funds to change the portfolio companies' management when its performance is unsatisfactory.

1.30 Would defining qualifying portfolio company in this manner facilitate compliance or would this approach make it easier for a company to achieve a "buyout" and thereby circumvent the intended scope of the exemption, given the fungibility of cash and the privately negotiated nature of typical venture capital transactions?

Some venture capital funds will want to fully or partly "buy out" the previous shareholders in order to achieve control. Buyouts do not always need to be financed through additional leverage (i.e. not all buyouts are leveraged buyouts).

1.31 Are there other capital reorganizations that would be consistent with the intent of our proposed rule but that would prevent a venture capital fund from satisfying the proposed definition?

Yes. The Commission should not regulate from whom the securities can be acquired or how the capital can be used.

1.32 Should the proposed definition specifically identify other types of pooled investment vehicles (e.g., real estate funds or structured investment vehicles) in which a fund seeking to satisfy the proposed definition could not invest?

No. The Commission should allow advisers to funds of venture capital funds to use the exemption. There is no indication that Congress did not intend the venture capital exemption to apply to funds of funds. Congress primarily seemed to be concerned about venture capital's contribution to create jobs. Fund of funds are an important investor class that provides capital to venture capital funds. If the intent is to provide venture capital in order to create jobs, then it should not matter that the capital is indirectly coming from a fund of funds that exclusively invests in venture capital funds. In addition, there is a danger that co-investments in holding companies through which a venture capital fund co-invests in portfolio companies together with other investors, such as other venture capital funds, could be deemed to be a pooled investment vehicle. Furthermore, a venture capital fund may want to make short-term investments in money-market funds as an alternative to placing money in bank accounts.

1.33 As we have noted above, Congressional testimony asserted that a key characteristic of venture capital funds is the provision of managerial assistance. Is this true in the industry generally?

The provision of managerial assistance to portfolio companies is *not* a key characteristic of a venture capital fund. The key characteristic of a venture capital fund is the provision of venture capital. Not all venture capital funds offer significant managerial assistance to all their portfolio companies that goes beyond the normal monitoring duties of a board of directors. In addition, not all venture capital funds have controlling stakes in their portfolio companies. I believe that Congress was primarily concerned about the main feature of providing venture capital to new businesses in order to create jobs.

1.34 Is this description easier to understand and apply than the definition in section 2(a)(47) of the Investment Company Act?

The Commission should not require venture capital funds to offer managerial assistance to portfolio companies or to actually provide managerial assistance to portfolio companies. The key characteristic of venture capital funds is the provision of venture capital and not whether they also offer managerial assistance or whether they have majority control over the portfolio companies.

1.35 Should the rule specify that the fund or its adviser actually provide assistance?

No. The rules should not even require the adviser to offer managerial assistance.

1.36 Should the rule specify how managerial assistance or control is to be determined in the case of venture capital funds that invest as a group if only one fund (or its adviser) provides the assistance?

No. The offering or provision of managerial assistance should not be required. However, if the Commission retains the requirement, it should only require one out of a group of venture capital funds to offer or provide the managerial assistance.

1.37 Should the rule specify the extent to which each fund (or its adviser) must offer or provide managerial assistance or adopt the approach of other regulatory definitions of "venture capital" funds, which impose strict numerical investment or ownership tests for determining whether a venture capital fund exercises supervision or influence over the operation or business of the operating company?

No. The offering or provision of managerial assistance should not be required even if the venture capital fund controls the qualifying portfolio company. What matters is the provision of risk capital to young business.

1.38 Should the rule specify that in all cases managerial assistance includes both the offer of assistance as well as the exercise of control?

No. Venture capital funds should neither be required to offer managerial assistance to nor to control portfolio companies.

1.39 Would the requirement to offer and potentially provide managerial assistance to all of a fund's portfolio companies result in potential demands on a fund or its adviser that could not be satisfied if all or a significant subset of a fund's portfolio companies accepted the offer?

This seems possible.

1.40 Alternatively, does the proposed definition provide a venture capital fund (including those that invest as a group) with sufficient flexibility to determine the scope of any managerial assistance or control it may seek to offer (or provide) to a portfolio company?

No. Venture capital funds should neither be required to offer nor to provide managerial assistance to or to control portfolio companies.

1.41 Should the rule specify other borrowing or financing terms or conditions that would nevertheless avoid this type of transformation?

No.

1.42 Do venture capital funds use lines of credit repeatedly but pay the outstanding amounts in full before drawing down additional credit?

Yes. Typically a short-term line of credit is used to finance an investment in a portfolio company before a capital call to investors can be made. The drawn capital is then used to repay the credit.

1.43 Should loans of this nature be included in the definition?

Yes. However, definitions relating to the use of the credit may be impracticable and hard to enforce.

1.44 Should the proposed rule specifically exclude commercial paper from debt issuances to avoid the potential that a venture capital fund could convert short-term debt into long-term debt by continuing to roll over its commercial paper issuances?

Yes. I have never seen a venture capital fund that issued commercial paper.

1.45 Should we increase or reduce the 15 percent threshold for short-term borrowing? If so, what is the appropriate threshold (e.g., 20, 10, or 5 percent)?

In my opinion, there is no need for a maximum threshold. Any limit could have the unintended consequence of preventing a venture capital fund to use a short-term bridge loan to invest in a portfolio company in anticipation of the next capital call if the investment amount exceeds this threshold. The fact that most of a venture capital fund’s portfolio companies do not generate positive EBITDA that can be used to finance debt will prevent a venture capital fund from obtaining excessive amounts of leverage on the portfolio company and on the fund level. Even mature portfolio companies can not be sold at short-notice. Any bank will be reluctant to provide significant amounts of debt to a venture capital fund unless the venture capital fund has sufficient uncalled capital commitments from investors with a high credit rating that can be used to repay the debt. A fund should be allowed to borrow up to the amount of its uncalled capital commitments.

1.46 Or should we define a venture capital fund as a private fund that does not borrow at all or otherwise incur any financial leverage?

No.

1.47 Would even the limited ability to engage in short-term borrowing or other forms of leverage encourage venture capital funds to incur other investment risks different from those typically associated with venture capital investing today?

No. The definition of a venture capital for purposes of the venture capital fund exemption is not the right place for rules that deal with the protection of investors.

1.48 Would a 120-day period, as specified in our proposed rule, create other investment risks for venture capital funds?

No.

1.49 Should the rule refer specifically to additional forms of borrowing not already identified?

No.

1.50 Do any or many venture capital funds borrow in excess of 120 days?

No.

1.51 Should the 15 percent limit not apply when a fund borrows in order to invest in a qualifying portfolio company and is repaid with capital called from the fund's investors?

Yes.

1.52 Would the 120-day limit alone achieve a similar result?

No, because a fresh loan could be used immediately after the repayment in order to achieve long-term financing through debt.

1.53 Should the 15 percent calculation be determined with respect to the total investment amount for each portfolio company? Would this standard be easier to apply?

No.

1.54 Is the phrase "extraordinary circumstances" sufficiently clear to distinguish the investor liquidity terms of venture capital funds, as they operate today, from hedge funds?

Yes.

1.55 Should the rule define when withdrawals by investors would be "extraordinary?"

No. However, it could provide examples.

1.56 Should the rule specify minimum investment periods for investors?

No. This may have unintended consequences for the ability of investors in evergreen funds to sell their interests in those funds if they need liquidity. Although investors cannot redeem their interests in the fund, they are able to sell their fund interests to other qualified investors at any time. This only results in changes in the ownership of the fund, but does not change the fact that the fund's long-term investments continue to be financed by long-term capital.

1.57 Could venture capital funds provide investors with "extraordinary" rights to redeem that could effectively result in redemption rights in the ordinary course?

This seems unlikely. However, the SEC could enforce such cases as willing breaches of the SEC's rules.

1.58 Should we address this potential for circumvention of the definition by establishing a maximum amount that may be redeemed during any period of time (e.g., 10 percent of an investor's total capital commitments)?

No. If an investors needs to withdraw from a fund because it would violate laws or regulations by continuing to hold an interest in the fund, the investors will need to redeem or sell 100% of interest in the fund as soon as possible and to have his uncalled capital commitments cancelled.

1.59 Would such a limit constrain investors in a way so as to prevent them from complying with other legal or regulatory requirements?

Yes. See above.

1.60 We request comment on a venture capital fund's representations regarding itself as a criterion under the proposed definition. Is our criterion inconsistent with current practice?

The criterion that a fund needs to represent itself to investors in its offering documents as a venture capital fund is appropriate. A description of the investment strategy is a key element of any private placement memorandum.

1.61 Does the proposed criterion regarding venture capital fund representations adequately address our concern that advisers should not be eligible for the exemption if they advise funds that otherwise meet the definitional criteria in the rule but engage in activities that do not constitute venture capital investing?

Yes. Non adherence to the investment strategy that was stated in the private placement memorandum would normally result in lawsuits by investors and in investors using the for-fault clauses in limited partnership agreements to remove the general partner.

1.62 We request comment on the requirement that a venture capital fund has to be private fund as defined in the Advisers Act and whether it appropriately reflects the expectation of Congress.

This appropriately reflects the expectation of Congress.

1.63 We request comment on whether the proposed rule should include other elements that were described in testimony as characteristic of venture capital funds or that distinguish venture capital funds from other types of private equity or private funds.

The proposed rule should not include other elements. Congress did not provide intent that they wanted to restrict the exemption for venture capital funds to funds that do not follow certain business practices or that have a certain structure. There is no congressional intent to specify rules that provide protections for investors.

1.64 Do venture capital advisers typically invest in the funds they manage?

Investment advisers to venture capital funds that are structured as self-liquidating limited life funds typically invest in the funds they manage. However, this may not always be the case and may not be the case for funds that are structured as evergreen funds.

1.65 Should we modify the proposed rule to include as a condition that advisers relying on the exemption under section 203(l) would invest in the venture capital fund at a specified minimum threshold?

No. There is no indication of congressional intent to restrict the exemption for venture capital funds to those funds with business practices that particularly protect investors or that require investment advisers to share any losses with investors. However, I would recommend to any qualified investors not invest in a private equity fund where the investment advisers does not invest a significant amount of his private net worth.

1.66 If so, what is an appropriate investment threshold – less than one percent, one percent, three percent, five percent, or somewhere in between?

The Commission should not require an investment by the investment advisers and should not specify a minimum threshold. A percentage of committed capital or of total assets is too inflexible. It will depend on the amount of the private net worth of the key employees of the investment adviser and on the negotiation power of the investors how much they are able to and want to invest. In the case of a very large fund, the private net worth may not be large enough and liquid enough to reach a particular percentage threshold. The definition of a venture capital fund for purposes of the venture capital fund exemption is not the right place to regulate investor protection measures.

1.67 Should the proposed rule be modified to specify that venture capital funds have a minimum term, for example, of 10 years?

No. However, self-liquidating limited life venture capital funds typically have a minimum term of 10 years. Evergreen funds have no limited life.

1.68 Should the proposed rule be modified to specify that a venture capital fund is one that does not have retail investors?

No. It will depend on U.S. securities law and on the securities laws of any foreign countries, whether a fund has any U.S. or foreign retail investors.

1.69 If so, how should "retail investor" be defined? Should "retail investor" exclude persons who are not "qualified clients" for purposes of the Advisers Act?

The definition of a venture capital fund for purposes of the venture capital fund exemption is not the right place to regulate investor protection. Personally, I would not recommend retail investors that are not qualified clients to invest in venture capital funds, private equity funds or hedge funds.

2. Exemption for smaller private fund advisers

2.1 The SEC should not include uncalled committed capital in the definition of AuM

The SEC's definition of assets under management should not include uncalled capital that was committed by investors to the private fund. Including uncalled committed capital would overstate the amounts of assets under management because it would include capital that is still under the management of the *investors*. As a consequence, uncalled committed capital is still substantially irrelevant both for purposes of investor protection and for purposes of systemic risk. Thus the inclusion of uncalled committed capital would not be consistent with the Congressional intent behind the registration of private fund advisers. The fact that the calculation of the fund's management fee is often based on committed capital (both called and uncalled) during the first few years of the life of a fund does not change the fact hat this capital has not been contributed to the fund yet and is thus not yet "managed" by the fund. In addition, a part of the uncalled committed capital may remain uncalled at the end of the life of private equity funds or venture capital funds and may thus never get invested. This happens frequently in practice when a fund does not find enough attractive opportunities to invest in portfolio companies during its investment period and cannot use the unused remaining committed capital to make follow-on investments in the existing portfolio companies after the end of the investment period. Most private equity fund agreements and venture capital fund agreements only allow capital calls for follow-on investment and to cover fees and expenses after the investment period. Funds typically draw down committed capital slowly over time. Furthermore, it would result in an inconsistent treatment of investment advisers that do not advise private funds with uncalled committed capital and investment advisors with other advisory activities. Moreover, a definition of the term *assets under management* that includes both assets that are on the balance sheet of the fund and uncalled committed capital does not reflect the use of this trade term (or technical term) in the private equity and venture capital industry. As a consequence, such a definition would exceed the statutory authority in section 211(a) IA to define trade terms and technical terms.

In the financial services industry the term *assets under management* commonly refers to the assets that are managed for investors and that are economically owned by the investors. In the private equity industry the term *assets under management* may refer to net assets that are attributable to investors. It may also refer to capital that was contributed by investors to active funds (i.e. called capital or capital drawn down) or to the capital that was committed by investors to active funds (i.e. funds that have not been dissolved yet).

Committed capital is often used for marketing purposes because it also includes undrawn committed capital and thus leads to a higher number that suggests a greater importance and a more extensive experience of the investment manager.

2.2 The SEC should use net assets attributable to investors instead of total assets

The SEC's definition of assets under management should not refer to the total assets on the balance sheet of a private fund. Such a definition would include assets that are financed by liabilities in addition to assets that were financed by investors. This definition would not be consistent with the meaning of the trade term assets under management in the private equity industry and in the venture capital fund industry. As a consequence, such a definition would exceed the SEC's statutory authority to define trade terms and technical terms. In addition, it would not be a suitable measure for a private fund's importance for the protection of investors, which is the primary objective of the federal securities laws.

The private equity fund industry usually does not use the term *assets under management* for the total assets on the balance sheet of a fund. In addition, both the Investment Company Act of 1940 and the rules and regulations relating to it distinguish between the terms *total assets* (gross assets) and *net assets*.[4] It is noteworthy to point out that the SEC's definition of small entities under the Investment Company Act of 1940 also refers to net assets rather than total assets.[5] In addition, the rules under the Investment Advisers Act of 1940 also distinguish between assets under management and total assets.[6] Since Congress chose the trade term *assets under management* rather than the term *total assets* or just the term *assets*, the SEC's rules should not refer to the total assets on the private fund's balance sheet, but should measure assets under management using the *net assets attributable to investors*.

Some funds, especially hedge funds use significant amounts of leverage at the fund level. In this case the assets that are invested by the fund and assets that were contributed by investors to the fund in the form of cash may differ significantly. In addition, private equity funds,

[4] Cf. Sec. 2(a)(46)(C)(iii) ICA, Sec. 2(a)(48)(B) ICA, Sec. 3(a)(C) ICA, Sec. 5(b)(1) ICA, Sec. 2(a)(32) ICA, Sec. 3(c)(7)(B)(ii)(II) ICA, Sec. 10(d)(6) ICA, 17 CFR 270.5b-1, 17 CFR 270.2a-4(a), form N-SAR page 29-30
[5] Cf. 17 CFR 270.0-10(a)
[6] Cf. 17 CFR 275.0-7(a)

venture capital funds and hedge funds typically do not charge management fees on assets that were financed through debt at the fund level.

The definition of the trade term "assets under management" that was contained in section 203A(a)(2) IA prior to the amendments made by the Dodd-Frank Act is suitable for investment advisers that provide classical investment advice or investment management for customer accounts rather than for private funds, because such accounts typically do not contain additional assets that are acquired through obtaining debt financing on behalf of the client. However, this definition is not suitable for private funds, because their balance sheets may also contain liabilities or parts of realized and unrealized profits that are attributable to the fund manager in the form of potential performance fees.

While the total assets on a fund's balance sheet are an indicator of the importance of a fund for purposes of systemic risk, the assets under management that are attributable to investors are an indicator of the importance of a fund for purposes of the protection of investors. In my opinion, the main objective of the federal securities laws is the protection of investors and the monitoring of systemic risk is only a secondary objective. However, the House Committee on Financial Services decided not to make the exemption for private fund advisers contingent on the absence of characteristics of systemic risk, such as the use of excessive leverage at the fund level.[7]

The SEC should define that the assets under management of private funds should be measured as the net assets attribute to investors. In the private equity industry and in the venture capital industry the *net assets attributable to investors* or *net asset value (NAV) attributable to investors* represent the total assets on the balance sheet less the liabilities and less the part of the retained realized or unrealized profits that would be attributable to the fund manager (e.g. performance fees) if all of the funds assets would be liquidated and all liabilities would be settled at the values they have on the balance sheet.

2.3 Accuracy of valuations of assets under management

I do not believe that Congress intended the Commission to regulate how investment advisers should value the assets of private funds. Requiring valuations of the fair value of assets would create extra burdens for investment advisers if such valuations are not already available because they are required by private funds' governing documents or produced voluntarily for other purposes. However, the use of fair values should be required when they are already available. In the absence of fair values, current cost (i.e. acquisition cost less partial sales and redemptions or impairments) is an acceptable alternative for investments in long-term assets by funds that do not allow their investors to redeem their interests.

The Commission should be mindful of the cost of valuing assets at their fair value compared to the benefit of using sometimes more accurate valuations for investment decisions. The valuation of assets for which no liquid market exists requires more effort, relies on subjective judgments and produces values that may differ substantially from the ultimate sales value. In addition, private equity funds and venture capital funds usually do not allow investors to redeem their interest in the fund and make any sales of fund interests subject to the approval of the fund manager. Typically there is no liquid market for interests in private equity funds with limited fund lives. Interests in such funds are very rarely sold and usually held until the fund has been fully liquidated and dissolved. As a consequence, investors can only rarely use the fair values that are disclosed to them for investment decisions whether they should buy or

[7] See footnote 1 infra.

sell an interest in a fund. The main use of fair values for making investment decisions happens when a fund manager solicits subscriptions to interests in a successor fund and discloses the fair values of the unrealized investments of the previous funds in the track record section of the private placement memorandum for the successor fund. Since the fair values of unrealized portfolio companies are used as terminal values in the internal rate of return calculation to show the performance of the previous funds, there is a risk of intentional misstatements of valuations and of intentional misstatements of material facts to auditors or of withholding material facts from auditors that audit those fair values. The incentives for intentional misstatements in private placement memorandums for funds that do not allow investors to redeem their interests in the fund are high, because the investors cannot leave the fund and the fund manager can at least cash in the management fee during the life of the fund (usually at least 10 years).

When no new funds are raised, investors in existing funds usually only use the fair value information from the quarterly reports for their own financial statements and to calculate the investment performance of their overall investment portfolio. The Commission should consider, whether the burden and cost of requiring fair values in periods where this information is unlikely to be used by investors for making investment decisions, is really justified by any remaining benefits.

2.4 Coordination with foreign securities regulators

I strongly recommend the Commission to review the legislation of foreign jurisdictions relating to investment advisers that advise private funds. The SEC should coordinate its record keeping and reporting and maybe any assets under management triggers in order to avoid conflicting duties for funds. In addition, the SEC should consider harmonized reports and agreements to exchange electronic reports with foreign securities regulators so that funds that have to report to multiple regulators only need to submit their reports once. Furthermore, the SEC should consider using its exemptive rulemaking authority to exempt investment advisers to private funds that are registered with foreign securities regulators and that are subject to substantively equivalent obligations.

In particular, the Commission should review the provisional final version of the European Union’s Directive on Alternative Fund Managers that has been passed by the European Parliament and that has been previously agreed with, but not yet passed by the Council of Ministers.[8] Since the assets under management thresholds are different anyhow, the Commission could and should have a definition of assets under management that is consistent with the meaning of this trade term in the financial services industry and that does not include assets on the balance sheet of a fund that are financed by debt. The Commission should also consider the European Commission’s provisional request for advice to the Committee of European Securities Regulators (CESR).[9]

2.5 Should we, alternatively, interpret section 203(m) as denying the private fund adviser exemption to a non-U.S. adviser that has other types of clients outside of the United States?

No. There would need to be other types of U.S. clients to warrant the protection of U.S. investors. Since the geographic location of assets or the location of the market where they are traded is hard to define for some private fund assets, such as private companies, providing investment advice

[8] http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2010-0393&format=XML&language=EN
[9] http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm

relating to those private fund assets from a place of business in the U.S. is a good proxy that indicates that the U.S. financial markets and systemic risk relating to those markets may be impacted by those funds.

2.6 If we adopt this alternative approach, should the exemption apply to a non-U.S. adviser even if not all of the non-U.S. funds it manages are offered in the United States?

I do not recommend this alternative approach, because there is a lack of jurisdictional interest in the protection of non-U.S. investors. If the SEC nevertheless opts for this alternative approach, the exemption should also apply to non-U.S. advisers even if not all of the non-U.S. funds they manage are offered in the United States.

2.7 We request comment on whether the method for calculating the relevant assets under management should deviate from the method in the proposed amendments to Form ADV instructions by, for example, excluding proprietary assets, assets managed without compensation, or uncalled capital commitments.

The method of calculating the relevant assets under management for purposes of the exemption in section 203(m) should be the same as the method in the proposed amendments to Form ADV. In my opinion, both methods should exclude uncalled capital commitments and should focus on the *net* assets that are attributable to the *investors* in the private fund.

2.8 Would the proposed approach result in advisers valuing their private fund assets in a generally uniform manner and in comparability of the valuations?

No. Even if the accounting standards for measuring assets at fair value in different bodies of accounting principles are similar, the valuation of assets that are not traded in a liquid market is highly subjective and judgemental and the valuations will not be comparable. For example, two underlying private equity funds, in which one of the funds of funds that I used to monitor was invested, both owned substantial stakes in an identical portfolio company, but used different audited fair values (even when extrapolating their ownership stakes to a 100% ownership).

2.9 We are not proposing to require advisers to determine fair value in accordance with GAAP. Should we adopt such a requirement?

No. In my experience, most European private equity funds that invest in mid-market companies use International Financial Reporting Standards (IFRS) with a carve-out for the standard that would require the fund to consolidate the portfolio companies individual financial statements into the fund’s consolidated financial statements and a second carve-out for the standard that would require the fund’s capital to be disclosed as debt on the passive side of the balance sheet simply because it can be repaid and because the fund’s governing documents require the fund manager to distribute the proceeds from the sale of portfolio companies to the fund’s investors. I have also seen European private equity funds that use U.K. GAAP or some other form of national GAAP. Some funds even use a body of accounting standards that allows them to value their investments in portfolio companies at cost and that perform unaudited separate valuations based on the International Private Equity and Venture Capital Valuation Guidelines[10] or the U.S. Private Equity Valuation Guidelines[11] outside of the audited financial statements.

2.10 If not, should we specify that advisers may only determine the fair value of private fund assets in accordance with a body of accounting principles used in preparing financial statements?

[10] Cf. http://www.privateequityvaluation.com/
[11] Cf. http://www.peigg.org/valuations.html

No. Some private funds may use accounting principles in preparing financial statements that do not require assets to be valued at fair value. The Commission should evaluate whether it wants to impose the burden and cost of valuations based on fair value on investment advisers and private funds if the investors do not already require such valuations from the private fund or the investment adviser. Fair values may not even be accurate and may materially differ from the ultimate value that can be realized in a sale of the asset. The difference between cost and fair value is primarily a difference in accuracy and the timeliness of the valuation. Those benefits should be compared against the cost and that fact that fair values of assets that are not traded in an active market are judgemental anyhow. The assets under management should be based on the net assets of the fund that are attributable to investors in accordance with the body of accounting principles used in preparing the financial statements. If those principles do not require the use of fair values, but if the investment advisers has produced fair values for other purposes, then the investment advisers should be required to replace the values of those assets with those fair values including counter-entries for unrealized gains or losses and to recalculate the net assets that are attributable to investors. I have performed such calculations for investments in private equity funds that did not include fair values in their financial statements, but that provided fair values outside of their financial statements.

2.11 We understand that GAAP does not require some funds to fair value certain investments. Should we provide for an exception from the proposed fair valuation requirement with respect to any of those investments?

Yes. A body of accounting principles may allow investments to be held at amortized cost if they are intended to be held until maturity. In addition, other assets on the balance sheet of a private fund, such as accruals and receivables may not be required to be valued at fair value.

2.12 Should we adopt a different approach altogether and allow advisers to use a method other than fair value?

Yes. An adviser should only be required to use fair values as of a certain point in time if it is already required by the private fund's governing documents or voluntarily already uses fair values for other internal or external purposes. In other words, the Commision's rules should not impose an incremental burden on investment advisers that advise private funds to produce fair values that are not available yet.

2.13 Are there other methods that would not understate the value of fund assets?

Methods using amortized cost less impairments may be sufficient for illiquid assets that generate regular income (e.g. interest, dividends, rental income) and that are intended to be held for a long term or until their maturity.

2.14 Should the rule permit advisers to rely exclusively on the method set forth in a fund's governing documents, or the method used to report the value of assets to investors or to calculate fees (or other compensation) for investment advisory services?

Yes and no. An adviser should be permitted to use those fair values that it reports to investors. However, if the adviser does not report fair values to investors, but performs valuations to determine fair values for other purposes it should be required to use those fair values.

2.15 What method should apply if a fund uses different methods for different purposes?

If several methods produce fair values, then the fair values that are disclosed to investors should be used. If several fair values are disclosed to investors as of the same balance sheet date (e.g. unaudited and later audited) then the audited fair values should be used. However, since it can take several months after the financial year until an audit report is available, the Commission should consider whether, it prefers the latest unaudited interim financial statements or the latest calculation of net asset value attributable to investors that is available over considerably older audited financial statements if more recent audit financial statements are not available yet.

2.16 Should we modify the proposed rule to require that the valuation be derived from audited financial statements or subject to review by auditors or another independent third party?

No. Not all valuations that are based on fair value are audited. In addition, even if they are audited, they are usually only audited once per year. Since the primary objective of those rules does not seem to be the protection of investors through full and fair disclosure, but disclosures to the SEC for regulatory purposes, the SEC should not require valuations to be audited unless audited financial statements are already available until the filing deadline for Form ADV.

2.17 Should compliance with the $150 million threshold be determined more or less frequently than quarterly?

Compliance with the $150 million threshold should be determined annually as for Form ADV. If the Commission chooses that assets under management should be measured using a fair value standard, it should be mindful that not all private funds provide quarterly financial reports or quarterly financial reports with updated fair values. In addition, the financial year of some private funds may not correspond to the end of the calendar year. Furthermore, it may take several months until quarterly or annual reports are issued by private funds to a fund of private funds. As a consequence, an adviser to a fund of private funds will only know months later whether it exceeded an asset threshold at the end of the previous quarter. The Commission's filing deadline for Form ADV and the date as of which the assets under management need to be reported for purposes of Form ADV and as of which they need to be measured for purposes of the small private fund exemption should reflect those constraints. A common method to approximately update the net assets attributable to an investor used by funds of funds is to take the latest available financial statements of an underlying fund, to add any capital contributions and to deduct any distributions that occurred since the date of those financial statements and a new measurement date and to calculate the net assets attributable to the investor as of the new measurement date.

2.19 Should the availability of the exemption under proposed rule 203(m)-1 be conditioned on annual valuation rather than quarterly valuation?

Yes. An investment adviser may not always have the power to control the manager of a private fund that it advises or to control the managers of private funds in which a fund of private funds that it advises is invested in. As a consequence, the investment manager may not be able to obtain quarterly valuations. In my experience some foreign private equity funds do not provide quarterly financial reports or do not updated the fair values of assets in their quarterly reports on a quarterly basis.

2.20 Should we adopt a different approach that more broadly applies the availability of the private fund adviser exemption to U.S. advisers?

No. Referring to a threshold of assets that are attributable to U.S. investors instead of investment advice from a place of business in the U.S. relating to assets would allow U.S. or foreign advisers that advise a private fund with a high amount of assets (and thus a potential for systemic risk) from a place of business in the U.S. to escape registration if they mostly have foreign investors and only have U.S. investors below the threshold for assets that are attributable U.S. investors. If foreign securities regulators do not require registration or systemic risk reporting in such cases, then such funds may escape any form of regulation.

An exclusion of assets that are advised by a non-U.S. place of business of a U.S. adviser would make sense from the point of view that those assets may not pose a systemic risk to the U.S. markets. However, if the assets are traded on a national securities exchange in the U.S. or traded over-the-counter in the U.S. or if they relate to U.S. real estate or U.S. debtors, such an exclusion could lead to circumventions by simply advising those assets from a place of business outside the U.S.

2.21 Alternatively, should we interpret "assets under management in the United States" by reference to the source of the assets (i.e., U.S. private fund investors)?

This method makes sense from the point of view of a fund's importance for purposes of investor protection, but it does not necessarily make sense from the point of view of a fund's importance for purposes of posing a systemic risk to the U.S. financial markets. Since regulation probably wants to cover both purposes it may be useful to use both triggers.

2.22 Do commenters view either of these alternatives, separately or in combination with our proposed approach, as more closely reflecting the intent of Congress in using the term "assets under management in the United States" and our regulatory interests?

If the protection of US investors is the primary regulatory objective, then a threshold of funds that are attributable to US investors is a good primary registration trigger (provided it cannot be circumvented by splitting investor funds among several affiliated investment advisers and among natural persons that are affiliated with those investment advisers). However, there may be investment advisers that manage large amounts of assets held by both US and foreign investors who each stay beneath US and foreign registration thresholds and thus would not trigger registration or reporting requirements. As a consequence, investment advisory services by a place of business in the US for a certain amount of assets that are attributable to US or foreign investors should serve as a secondary trigger for registration or reporting requirements.

2.23 Would either alternative approach be easier for advisers to comply with than the one we are proposing to adopt?

I believe that smaller private equity or venture capital funds are more likely to invest their assets in one country rather than in a region of countries (e.g. North America) or on a global basis. It is easier to determine whether an investment adviser has a place of business in the U.S. than to identify whether all investors are U.S. persons at the time they subscribe to interests in a fund.

3. Exemption for foreign private advisers

3.1 Or should we require a different calculation? For example, should foreign private advisers be permitted to exclude proprietary assets or assets they manage without compensation?

If investor protection is the main policy objective behind the registration and reporting rules, then the rules should permit, but not require the exclusion of assets that are owned by the investment manager and knowledgeable employees of the investment manager regardless whether they are managed with or without compensation.

3.2 We request comment on whether any proposed rule should provide that an adviser must take into account the activities of its advisory affiliates when determining eligibility for an exemption. For example, should the rule specify that the exemption is not available to an affiliate of a registered investment adviser?

The Commission should try to anticipate circumventions of its registration or reporting rules for its investment advisers. It should not be possible to circumvent asset thresholds by establishing several investment adviser entities that are directly or indirectly controlled by substantially the same shareholders and by splitting clients and assets between those entities or by having a part of the clients directly advised by natural persons that are affiliated persons of the investment adviser or are employed by the investment adviser. While investment advisers that have a place of business in the U.S., but that only have a small amount of assets under management will still be registered with a state securities commission, non-U.S. advisers that have U.S. clients or that advise funds with U.S. investors may not be registered with any foreign securities regulator although they have a substantial amount of assets from non-U.S. investors.

4. Priorities for examinations of and the regulation of private equity funds

4.1 Priorities for examinations of private equity funds

The SEC's current requirements for investment advisors and the areas that are checked by the SEC's staff in examinations seem to be focused on investment advisors that invest in publicly traded securities. However, private equity funds almost exclusively invest in private companies. Only the larger private equity funds sometimes acquire public companies or sell private companies by taking them public through a listing on a stock exchange. As a consequence, routine examinations to check for front-running or insider trading would usually be a waste of examination resources. Examinations resources should focus on the main risks of material misstatements of facts and the omission of material facts in private placement memorandums and in quarterly reports to investors. As the valuations of portfolio companies that have not been sold yet have an effect on past returns through their use as terminal values in internal rate of return calculations, misstatements of valuations and omissions of information to auditors that audit valuations are a concern. Since investors are primarily interested in the experience of the people who work for the fund manager rather than in the brand name of the fund manager and ask for this information in their investment due diligence, misstatements or omissions relating to the incentives to retain staff or about the reasons for staff leaving the fund manager are another concern. A high staff turnover is an indicator of potential problems. Examination staff should not rely on explanations of the investment adviser for the reason for staff turnover, but should contact former employees to see whether they actually left or whether their employment was terminated because of disagreements about the compliance with securities laws or material weaknesses in internal control and in the compliance system.

4.2 Custody rules for the indicia of ownership of assets for private equity funds

In addition, investments in private companies typically only exist in book entry from in the shareholder register of the private company and are not evidenced by stock certificates or are only evidenced through registered stock certificates that can only be transferred with the approval of the shareholder and the other shareholders. The same is true for the investment of a fund of private equity funds in its underlying private equity funds. The limited partnership interests are usually not evidenced through certificates and can only be transferred with the approval of the general partner. Stealing such a certificate is useless because it cannot be sold without the written approval of the owner and typically even requires the approval of the other shareholders. As a consequence, any rules that require the indicia of ownership to be maintained in a special way or to be held by an outside custodian of by a U.S. bank are not necessary and only create costs that are ultimately borne by investors. The SEC should liaise with the U.S. Department of Labor that the DoL clarifies what the indicia of ownership in shares of a private company or of an interest in a limited partnership are and whether it wants to require fund managers that manage plan assets to spend significant parts of those plan assets on fees on keeping the indicia of ownership of private companies and private funds in vaults and safes at U.S. banks for purposes of the DoL's plan asset regulations.

I appreciate the opportunity to comment on these matters. Please do not hesitate to contact me by e-mail if you have any follow-up questions.

Respectfully submitted,

Georg Merkl