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January 24, 2011

VIA ELECTRONIC DELIVERY

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

Re: Release No. IA-3110 (File No. S7-36-10): Rules Implementing Amendments to Investment Advisers Act of 1940)[1]; and

Release No. IA-3111 (File No. S7-37-10): Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers).[2]

Dear Ms. Murphy:

We respectfully submit this letter in response to a request by the Securities and Exchange Commission (the "Commission" or "SEC") for comments regarding the above-referenced proposing releases. The Implementing Release and the Exemptions Release propose new rules and rule amendments (the "Proposed Rules") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), that would implement new exemptions from the registration requirements of the Advisers Act. The Proposed Rules are designed to give effect to provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and primarily seek to clarify the scope of three key exemptions − the first for foreign private advisers (the "Foreign Private Adviser Exemption"), the second for advisers to venture capital funds (the "Venture Capital Fund Adviser Exemption"), and the third for certain advisers to private funds (the "Private Fund Adviser Exemption").

Dechert LLP is an international law firm with a wide-ranging financial services practice that serves clients in the United States and abroad. Our clients include, among others, registered and unregistered investment advisers of all sizes that manage accounts and provide investment advice to registered investment companies and private funds domiciled in a variety of jurisdictions. Although we have discussed certain matters addressed in the Proposed Rules with some of our

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1 75 FR 77052 (Dec. 10, 2010) (the "Implementing Release").

2 75 FR 77190 (Dec. 10, 2010) (the "Exemptions Release").

clients, the comments that follow reflect the views of a group of attorneys in our financial services practice, and not necessarily the views of all members of our financial services group, the firm, or any client of the firm.

We applaud the Commission for its extensive research regarding industry practices and its efforts to tailor the Proposed Rules to strike the delicate balance between protecting investor interests and avoiding unnecessary and ineffective regulatory burdens on investment advisers. However, we offer these comments to address a few areas where we believe the Commission either should provide more guidance to industry participants or should reconsider its approach.

1. Uniform Calculation for Regulatory Assets Under Management

We generally agree with the Commission's initiative in creating a single uniform method of calculating an adviser's assets under management ("AUM") for purposes of determining an adviser's registration status ("Regulatory AUM"). However, certain specific instructions proposed for the calculation of Regulatory AUM in the proposed revised Form ADV (the "Revised Form ADV") and described in the Implementing Release introduce unnecessary confusion and the potential for Regulatory AUM to not reflect the true measure of an adviser's business.

The Commission proposes that advisers should "be required to include in their Regulatory AUM securities portfolios for which they provide continuous and regular supervisory or management services, regardless of whether these assets are proprietary assets, assets managed without receiving compensation, or assets of foreign clients."[3] Furthermore an adviser would not be allowed to "subtract outstanding indebtedness and other accrued but unpaid liabilities, which remain in a client's account and are managed by the adviser."[4]

a) Gross Assets Calculation

First, we urge the Commission to continue to allow an adviser to use the net value of its AUM when calculating its Regulatory AUM. Calculating Regulatory AUM on a gross basis would be confusing to industry participants, including investors, broker-dealers, counterparties, and regulators, who have become accustomed to the industry standard of AUM being expressed on a net basis. Reporting gross AUM to clients artificially inflates an adviser's AUM and misrepresents the actual size of the adviser's business and its AUM.[5] Further, requiring the use of

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3 Implementing Release, at 77056.

4 *Id.*

5 We expect the Commission has already considered the potential confusion to clients because the Implementing Release allows advisers to continue calculating their AUM as it always has in communications to clients, which may differ from the advisers' Regulatory AUM. Implementing Release, at 77056. Furthermore, Item 4 of the Form ADV, Part 2 provides guidance to advisers that they may use different computation methods when computing client assets managed and AUM. Allowing an adviser to maintain different approaches to calculating their AUM could

gross assets will make AUM more volatile, potentially inflating advisers' Regulatory AUM and causing advisers to exceed registration thresholds based on the amount of leverage used in its management of portfolios and potentially requiring de-registration if an adviser deleverages one or more portfolios. Finally, not allowing an adviser to subtract accrued but unpaid expenses would cause not only the confusion described above but also cause the timing of payments, which may be based on a variety of financial considerations, to affect the registration status of an adviser.

Additionally, allowing an adviser to report AUM on a net basis would obviate the need to clarify how an adviser should treat any short positions and whether real estate held by a private fund should be valued taking into account any outstanding mortgages for reporting purposes. If, in the alternative, Regulatory AUM is calculated using gross assets, we request guidance as to how an adviser should report its short positions and real estate.[6]

The Revised Form ADV would ask for an adviser to disclose the gross and net assets for any private fund it manages for the purposes of understanding the extent of leverage a private fund employs.[7] If the Commission is concerned about an adviser's use of leverage and its contributions to systemic risk, such information would be readily available in the Revised Form ADV, and should not be encompassed in the calculation of Regulatory AUM for purposes of determining an adviser's ability to meet the SEC's registration threshold or an adviser's eligibility to rely on the Foreign Private Adviser Exemption or the Private Fund Adviser Exemption. Given the small size of advisers not eligible to register with the SEC due to having Regulatory AUM of less than $100 million, the narrow scope of the Foreign Private Adviser Exemption, and the reporting obligations of advisers relying on the Private Fund Adviser Exemption, the benefits of requiring advisers to calculate Regulatory AUM based on gross assets (*i.e.*, the ability to collect data concerning systemic risk) are outweighed by the resulting industry confusion, volatility, and additional time and cost injected in calculating Regulatory AUM.

b) Non-Fee Paying and Proprietary Assets

We suggest that the Commission continue to permit advisers to exclude non-fee paying assets and proprietary assets when calculating Regulatory AUM. Legitimate business reasons exist for

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cause confusion and result in errors of calculation that are misleading to clients, broker-dealers, counterparties, and regulators.

6 We recommend that where an adviser manages an entity that can rely on multiple exemptions from registration under the 1940 Act, (for example, a fund that would be exempt under Section 3(c)(5) of or Rule 3a-7 under the 1940 Act), the adviser should be able to treat that entity as a "private fund" for purposes of the Private Fund Adviser Exemption, so long as such entity would be able to rely in the alternative on either 3(c)(1) or 3(c)(7). We ask that the Commission provide clarification on how the portfolio assets are treated for such entities. The instructions to Revised Form ADV suggest that, for example, any pooled vehicle that invests in "real estate" funds should for all cases be treated as a private fund for purposes of Regulatory AUM.

7 Implementing Release, at 77066; *See* Instructions to Item 11.f of Revised Form ADV.

providing advisory services without compensation, including as an incentive for key employees to remain at the advisory firm and providing advisory services to principals of the advisory firm. Historically, non-fee paying accounts have not been treated as "clients" of an adviser since the statutory definition of an adviser is a person who provides investment advice for compensation. Similarly, prior guidance suggests that proprietary assets be excluded because the statutory definition of an adviser is a person who provides investment advice to others.[8] The Commission has not advanced any regulatory justification for departing from this longstanding approach. Just as the Commission is collecting information on the use of leverage as described above, we suggest the Revised Form ADV include a section where an adviser would detail the non-fee and proprietary assets it manages instead of requiring such components to be included in calculating an adviser's Regulatory AUM.

2. Proposed Method for Determination of Exemption

The Dodd-Frank Act effectively raised the AUM threshold required for registration with the Commission from $25 million to $100 million and created the Foreign Private Adviser Exemption and the Private Fund Adviser Exemption that are each based on an adviser's Regulatory AUM, among other requirements. We suggest that, instead of taking a snap-shot of an adviser's Regulatory AUM as of a particular date for purposes of evaluating its eligibility to either register with the SEC or qualify for an exemption based on its Regulatory AUM, the rolling average of its Regulatory AUM over the past 12 months, or some other time period, should be used. Using a rolling average will provide a clearer picture of an adviser's relevant Regulatory AUM and will avoid significant regulatory consequences and disruption to an adviser's business resulting from aberrational changes in Regulatory AUM which may be temporary but which could require an adviser to register or deregister.

3. Expansion of Private Fund Reporting

We generally agree with the information the Revised Form ADV would be soliciting with respect to private funds managed by registered or exempt reporting advisers. We note, however, that Part A of the new Schedule D in Revised Form ADV would require advisers to break down the assets and liabilities held by a private fund by class and categorization in the fair value hierarchy established under U.S. generally accepted accounting principles ("GAAP").[9] As the Commission acknowledges, many advisers use international accounting standards instead of GAAP.[10] While international accounting standards require substantially similar information as GAAP, it would be unduly burdensome on advisers using international accounting standards to reconcile their financial information to GAAP and accurately provide the GAAP fair value hierarchy requested in revised Schedule D. To give effect to the Commission's statement that it is "not proposing to

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[8] We also ask the Commission to clarify that the inclusion of proprietary assets would not include an adviser's working capital.

[9] See Schedule D, Section 7.B.1.A, question 12 of Revised Form ADV.

[10] Implementing Release, at 77066; Exemptions Release, at 77207.

require advisers to determine fair value in accordance with GAAP," we suggest that the Revised Form ADV be amended to allow an adviser to report its assets and liabilities in accordance with the accounting standards utilized by the adviser in its business.[11]

4. **Foreign Private Adviser Exemption**

The Foreign Private Adviser Exemption was established by the Dodd-Frank Act, and the Commission has sought to clarify the scope of the Foreign Private Adviser Exemption through proposed rule 202(a)(30)-1. We have several comments and observations relating to the Foreign Private Adviser Exemption generally and proposed rule 202(a)(30)-1 specifically.

a) The $25 Million Threshold

New section 202(a)(30) of the Advisers Act provides the SEC with the opportunity to increase the $25 million threshold in accordance with the purposes of the Advisers Act. As enacted by the Dodd-Frank Act and clarified in proposed rule 202(a)(30)-1, the Foreign Private Adviser Exemption is very narrow and will cause numerous foreign investment advisers, many of which may already be subject to regulatory oversight by foreign regulators, to register with the SEC. We believe the $25 million standard is effectively too low and could cause the registration threshold to be crossed inadvertently by advisers who have a single U.S. client. We do not believe the Congressional intent behind the Dodd-Frank Act was to subject such foreign advisers to the U.S. regulatory scheme. We propose increasing this amount to $100 million in order to permit advisers that do not actively seek U.S. investors to continue their business and effectively rely on the Foreign Private Adviser Exemption.

b) Definition of "In the United States"

We strongly agree with the Commission's approach in proposed rules 202(a)(30)-1 and 203(m)-1 in which a territorial approach is used to outline the parameters of the definition of "in the United States" and evokes the well-developed law and interpretations of a "U.S. person" under Regulation S under the Securities Act of 1933, as amended (the "Securities Act").

Proposed rule 202(a)(30)-1 also includes a "Note to paragraph (c)(2)(i)" that specifies that a person that is currently in the United States does not need to be treated as "in the United States" for purposes of the rule if the person was not "in the United States" at the time of becoming a client or, in the case of an investor in a private fund, at the time the investor acquired the securities issued by the fund. The note provides helpful relief at a time when advisory clients often move across international borders while keeping an existing relationship with a financial institution. The initial investment decision to invest in a private fund is no different from the decision of a client to begin an advisory relationship with an adviser, and should therefore not be treated differently for purposes of the definition of "in the United States." For this reason, we

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[11] Exemptions Release at 77207.

propose that the note be expanded with respect to private fund investors to also include additional investments in a fund by such investors. This expansion would be consistent with the portion of the note as it relates to "clients" who, as a result of the note, may continue to be serviced by a foreign adviser without causing the adviser to become subject to registration, even after they move to the United States. The change would prevent continuing investments made in private funds (many of which could actually be foreign retail funds, such as European UCITs) through routine or automatic investment plans from causing a foreign adviser to become subject to U.S. registration.

c) "Investor" Definition and SEC Interpretations

We note that proposed rule 202(a)(30)-1(c)(1) generally defines the term "investor" in a private fund by reference to sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940, as amended (the "1940 Act"). We agree with the Commission's approach in using the framework that advisers already use to evaluate an investor's eligibility for investing in a private fund.[12]

We are concerned, however, with the implications of the interpretive language regarding look-through provisions that would require an adviser to count any holder of an instrument (such as a total return swap or similar instrument) that effectively transfers the risk (but not necessarily the other attributes) of investing in the private fund from the record owner as an investor to a third-party.[13] Structured products, the returns on which are based in part upon the returns of a reference fund, are created for a variety of legitimate business reasons, including for example principal protection, leverage, tax efficiency, and regulatory considerations. End users (purchasers) of these products enter into a contract with a financial institution counterparty. They have counterparty risk with respect to the financial institution that created the product and have no privity with the fund or the manager. The financial institution may, but is not required to, hedge its exposure under the swap by investing in the reference fund, and sometimes it does not do so. Even, if the financial institution does invest in the fund, the adviser may not know that the institution making the investment in the fund has created a structured product that references the fund. Therefore, it is impractical and inappropriate to require a look-through.[14] Structured

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12 Advisers to private funds relying on section 3(c)(1) of the 1940 Act apply the look-through provisions regarding beneficial owners when counting investors, and advisers to private funds relying on section 3(c)(7) of the 1940 Act apply the standards of evaluating the qualified purchaser status of its investors.

13 Exemptions Release, at 77212. It is also not clear whether the look-through would include the creator or writer of the structured product or its customers or both.

14 If the look-through requirement is retained, we urge the Commission to provide a safe harbor from the look-through provisions for advisers who take reasonable precautions to avoid such transfer of risk, such as by obtaining representations from investors in a private fund's subscription and offering documents that the investor will not use the investment in the fund in connection with a structured product without the express consent of the adviser. In such circumstances, a look-through would be required only in circumstances where the adviser has consented to the arrangement.

instruments serve as a legitimate investment strategy and, provided they are not utilized in contravention of section 208(d) of the Advisers Act and not entered into for purposes of circumventing the 1940 Act for counting purposes under section 3(c)(1) or determining the qualified purchaser status of an investor for purposes of section 3(c)(7), should not require the use of a look-through.

The Exemptions Release also imposes a look-through approach in the case of master-feeder structures that would require an adviser to count the holders of securities of feeder funds as investors in a master fund. Master-feeder structures serve a legitimate purpose in helping advisers structure funds in the most efficient manner for its investors, taking into account cost, tax, regulatory, and other considerations. By creating a master-feeder structure, advisers are able to offer a single investment strategy to accommodate the differing needs of investors in a cost-effective manner by making it possible to commingle all assets in a single trading vehicle. Where the master fund has no direct investors (other than the feeder funds), it should not be viewed as a "fund." Previous SEC staff guidance indicates that the staff will typically look-through transactions when, in contravention of section 48(a) of the 1940 Act and section 208(d) of the Advisers Act, a transaction is structured for circumventing the requirements of the applicable statute.[15] Requiring a look-through in master-feeder structures would impose unnecessary structuring burdens on advisers, despite the fact that there are legitimate reasons for such structures that benefit investors and do not run afoul of section 48(a) of the 1940 Act or section 208(d) of the Advisers Act.

Proposed rule 202(a)(30)-1(c)(1)(A) would treat "knowledgeable employees" (as defined in rule 3c-5 of the 1940 Act) as owners with respect to a private fund, even though these persons are not counted for most purposes of sections 3(c)(1) and 3(c)(7) of the 1940 Act. The Commission promulgated the knowledgeable employee safe-harbors for sections 3(c)(1) and 3(c)(7) in response to the Congressional mandate in the National Securities Markets Improvement Act of 1996 to allow certain informed insiders to invest in a private fund without causing the fund to lose its exception under the 1940 Act.[16] Congress believed knowledgeable employees that participate in the management of a fund's investments are deemed to not need the protections of the 1940 Act.[17] Given this backdrop, we see no reason for the SEC to change its approach in counting knowledgeable employees as "investors" in a private fund for purposes of the Foreign

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15 *See American Bar Association Section of Business Law* (pub. avail. April 22, 1999) ("*ABA Letter*") and *Cornish & Carey Commercial, Inc.* (pub. avail. June 21, 1996).

16 Pub. L. No. 104-290 (1996) at section 209(d)(3); *See ABA Letter*.

17 S. Rep. No. 293, 104th Cong., 2d Sess. 10 (1996) ("Generally, these investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.")

Private Adviser Exemption, and instead we urge the SEC to maintain a consistent approach in the treatment of knowledgeable employees.[18]

d) Counting Clients

For purposes of the Foreign Private Adviser Exemption, proposed rule 202(a)(30)-1 counts clients by using the client counting safe harbor currently found in rule 203(b)(3)-1, except that it does not allow an adviser to exclude clients for which it receives no compensation.[19] As previously discussed above in Section 1 with respect to requiring an adviser to include non-fee paying assets in calculating Regulatory AUM, we do not believe it is appropriate to include persons from which no compensation is received as clients for purposes of the Foreign Private Adviser Exemption. In many instances, advisers manage the assets of employees and principals of the firm and their family members, and use such services as a legitimate compensation arrangement to retain talented employees. Advisers should not be penalized and forced to include such individuals as clients, thereby jeopardizing their eligibility under the Foreign Private Adviser Exemption.

5. <u>Private Fund Adviser Exemption</u>

a) The Definition of Qualifying Fund Should Be Expanded

The Private Fund Adviser Exemption applies to an adviser that only advises "qualifying private funds," which is defined as "any private fund" not registered under the 1940 Act and not treated as a business development company. The Dodd-Frank Act added the definition of "private fund" to the Advisers Act and limited it to any issuer that is excepted from the definition of an investment company by sections 3(c)(1) and 3(c)(7) of the 1940 Act.[20] Offshore private funds that do not maintain a jurisdictional nexus with the United States (*i.e.*, do not offer securities to U.S persons or do not use the U.S. mails and instrumentalities to offer securities) are technically not relying on section 3(c)(1) or 3(c)(7) to be excepted from the definition of an investment company. Upon a plain reading of the statute, this lack of reliance on section 3(c)(1) or 3(c)(7) would seem to disqualify such an offshore fund from the definition of a "private fund." We do not believe the Commission intentionally aims to limit the Private Fund Adviser Exemption in contravention of the Commission's past interpretive guidance.[21] In *Goodwin Proctor*, the SEC staff concluded that an offshore fund not registered in the United States under the 1940 Act could make a private offering within the United States to qualified purchasers in accordance with section 3(c)(7) without violating the 1940 Act prohibition on marketing offshore funds in the

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18 Individuals qualifying as "knowledgeable employees" are also considered "qualified clients" under rule 205-(3)(d)(1)(iii) and are therefore not prohibited from being changed a performance fee.

19 Exemptions Release, at 77210

20 See Section 202(a)(29) of the Advisers Act.

21 See *Goodwin, Proctor & Hoar LLP (*pub. avail. Feb. 28, 1997) ("*Goodwin Proctor*") and *Touche, Remnant & Co*. (pub. avail. Aug. 27, 1984).

United States absent an order from the Commission.[22] We believe the Commission's intent is to follow its past guidance, and as such request the Commission include clarification language either in the rule itself or in the relevant adopting release explaining that an offshore fund that is privately offered in the United States in reliance on *Goodwin Procter* should be treated as a "private fund" for purposes of the Private Fund Adviser Exemption.

Further, we do not believe the definition should be limited to issuers that are excepted from the definition of an investment company by section 3(c)(1) or 3(c)(7). Rather, it should be expanded to include any commingled vehicles to the extent the owners of such vehicles are sophisticated persons equivalent to the standards applicable to section 3(c)(1) or 3(c)(7) vehicles. In particular, the Commission should extend the definition to include issuers relying on sections 3(c)(5), 3(c)(6), and 3(c)(9) of the 1940 Act, as well as issuers compliant with rule 3a-7.

b) Assets Managed in the United States

Under proposed rule 203(m)-1, all of the private fund's assets of an adviser with a "principal office and place of business in the United States" would be considered to be "assets under management in the United States." Conversely, a non-U.S. adviser would need to only count private fund assets it manages "from a place of business in the United States" toward the $150 million exemption.

While we support this approach, we ask that the Commission provide some guidance as to what level of activity from a U.S. office constitutes "regularly provid[ing] investment advisory services, solicit[ing], meet[ing] with, or otherwise communicat[ing] with clients" such that the U.S. office would be deemed a "place of business in the United States."[23] We find that foreign advisers may have offices or affiliates in the United States from which certain limited activities may occur, such as research or due diligence. In that case, the U.S. office or affiliate of a foreign adviser should not be deemed a "place of business" if activities are limited to research, analysis or due diligence, as long as it does not "hold himself out" as an adviser by regularly meeting with clients, conducting marketing activities or providing regular and continuous investment advice to a client from the United States.

Further, we ask that the Commission include clarification that an adviser's "place of business" should be determined on an entity-by-entity basis. The SEC should make clear that the presence of an affiliated adviser in the U.S. does not create any presumption of a place of business for the non-U.S. affiliate.

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22 See Section 7(d) of the 1940 Act.

23 Proposed rule 203(m)-1 defines "Place of business" with reference to Rule 222-1(a) of the Advisers Act.

6. Proposed Venture Capital Fund Adviser Exemption

As the Commission indicates, venture capital funds do not pose great systemic risk to the economy and as a result should not be subject to unnecessarily strict regulations. We note that the Commission sought to draft the Venture Capital Fund Adviser Exemption based on its understanding of current industry practices, and we therefore offer these comments on the proposed rule to assist the Commission in tailoring the rule accordingly.[24]

a) Permitted Fund Holdings

Under proposed rule 203(l)-1(a)(2), a venture capital fund may only own securities issued by a qualifying portfolio company, cash, cash equivalents, and short-term U.S. Treasuries. We have outlined below our comments with respect to each of these elements of a venture capital fund's permitted portfolio holdings.

i) Definition of Qualifying Portfolio Companies

(1) Under Control of a Public Company

The definition of a "qualifying portfolio company" requires that, at the time of any investment by the venture capital fund, the portfolio company is not publicly-traded and does not control, is not controlled by, or under common control with, another company that is publicly traded.[25] We ask the Commission to consider limiting the control aspect of this element to allow companies under the control of a public company to be eligible as a "qualifying portfolio company."[26] Many large, publicly-traded companies have established subsidiary companies in the early stages of development; and, while the publicly-traded parent company may control the new subsidiary, the parent company may seek to raise capital in the market from venture capital funds. Such a restrictive definition of a "qualifying portfolio company" would be in contravention of the Congressional intent to allow venture capital funds to facilitate capital raising.

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24 Exemptions Release, at 77193.

25 Proposed rule 203(1)-1(c)(4(i).

26 We also request that the Commission consider temporarily limiting the control element to only apply at the time of the venture capital fund's initial investment. As currently drafted, the proposed rule ignores the possibility that the adviser may be under control of a public company. In such a scenario, such advisers would be placed in a competitive disadvantage because they would be unable to make follow-on investments in a portfolio company if the prior investments place them in a position of control.

(2) Ability to Invest in Funds

The definition of a "qualifying portfolio company" specifically excludes investment companies, private funds, and commodity pools.[27] We suggest the Commission modify this definition to allow venture capital fund-of-funds. The Exemptions Release simply states that Congress did not intend to include venture capital fund-of-funds when establishing the Venture Capital Fund Adviser Exemption.[28] We found no indication in the legislative history of the Dodd-Frank Act that Congress would be opposed to a private fund that solely invested in venture capital funds, and believe the Commission is limiting the Venture Capital Fund Adviser Exemption without the Congressional mandate to support such limitations. A manager of a fund that invests solely in venture capital funds should not be subject to greater regulatory scrutiny than the managers of the underlying venture capital funds in which the fund-of-funds invests, provided there is full disclosure to investors about the risks and conflicts of a fund-of-funds arrangement and the potential layering of fees and charges.

In the alternative, if the Commission decides to continue to exclude advisers to fund-of-funds from relying on the Venture Capital Fund Adviser Exemption, we propose that the final rule allow for an adviser to manage a venture capital fund that enables the fund to make limited investments in "incubator" funds if there is a legitimate business purpose for allowing the investment. We note that many venture capital funds invest in "incubator" funds as a method of ensuring participation in an investment opportunity at a very early stage and propose that permitting a venture capital fund to allocate up to 20% of its committed capital to such vehicles might be appropriate to facilitate these arrangements. We do not believe this limited exception should raise a concern that a venture capital fund is structured as a fund-of-funds, which the Exemptions Release cites as a reason for including the exclusion of funds from the definition of a "qualifying portfolio company." Because investors in a venture capital fund have the negotiating ability to affect the terms of the venture capital fund's investment strategy and eligible portfolio companies in which the fund may invest, we suggest the Commission allow investors and advisers to negotiate the parameters of potential eligible portfolio companies.

(3) Debt Financing

In order to be a "qualifying portfolio company," a company may not borrow or issue debt obligations in connection with the venture capital fund's investment.[29]

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27 Proposed rule 203(l)-1(c)(4)(iv).

28 Exemptions Release, at 77197.

29 Proposed rule 203(l)-(c)(4)(ii).

We request that the Commission modify this restriction so that a venture capital fund has some ability to provide debt financing to a portfolio company if it is in connection with or will support an equity investment and serves a legitimate operating or business purpose, and does not turn the venture capital fund into a "leveraged buyout fund," which the Commission states is a subset of private equity funds not intended by Congress to be included in the Venture Capital Fund Adviser Exemption.[30] We believe this restriction will unnecessarily hamper a portfolio company's flexibility in creating its own capital structure in a manner that will facilitate capital raising. For example, a venture capital fund, in connection with a previously made equity investment in a portfolio company, may decide to provide debt financing to the portfolio company to allow the portfolio company to raise cash without issuing more equity. Portfolio companies may face situations where additional cash is needed, but cannot attract new capital because of the existing capital structure and potential investor concerns of insolvency. In such a situation, a venture capital fund may choose to inject more money in the portfolio company only if such additional investment enters the capital structure as debt and therefore has priority over equity investments. Under the proposed rule as currently drafted, this flexibility in capital structuring would be prohibited.

Further, we suggest that the proposed rule should also permit a limited percentage, for example 10%, of bridge financings that are not necessarily convertible into equity for the same reasons discussed above.[31] Again, we note the negotiating position investors in venture capital funds maintain and the resulting leverage investors have in inserting appropriate investment limitations in the venture capital fund's governing documents, and therefore restrictive regulation by the SEC is not necessary.

ii) Buyout of Existing Shareholders

Proposed rule 203(l)-1(a)(2)(i), requires that 80% of the equity securities of each qualifying portfolio company owned by a venture capital fund must be acquired directly from the qualifying portfolio company. While we recognize the SEC's concern that venture capital funds should not function as "buyout funds," we recommend that the SEC consider allowing a venture capital fund to acquire securities from existing investors or employees if a legitimate business purpose exists for such a transaction, such as if an investor desires to abstain from continuing to fund a particular portfolio company or the exercise of a right-of-first-offer on a sale or buyout of existing investors (including employees) in need of liquidity.

Given the various legitimate reasons why a venture capital fund may not acquire its securities directly from a qualifying portfolio company, we suggest that the proposed rule require that the

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30 Exemptions Release, at 77197.

31 The Exemptions Release confirms that bridge financing in the form of instruments that are ultimately convertible into a portfolio company's common or preferred stock would meet the definition of an "equity security for purposes of the rule." Exemptions Release, at 77196.

20% allowance for secondary purchases in the proposed rule be increased to 45%. The 55% threshold has been used previously by the Commission staff in interpretative guidance in determining what level of activity rises to "primarily," as that term is used in various rules under the 1940 Act, and is therefore a familiar test for the Commission and advisers.[32] Implementing the 55% threshold would effectively change the proposed rule to allow a venture capital fund to "primarily" purchase its securities directly from the qualifying portfolio company.

iii) Short-Term Investments

Proposed rule 202(l)-1(a)(2)(ii) limits short-term investments to U.S. Treasuries with a remaining maturity of 60 days or less. We believe that the concern that a venture capital fund will be trading in and out of fixed income securities, or that any such short-term investments are something other than conservative cash management for the fund, is unfounded. Our experience indicates that short-term investment returns generally are distributed to investors in the fund in proportion to invested capital and a general partner or adviser will typically not receive a "carried interest" on such short-term investments. Because these investments are not a profit center for a venture capital fund, we urge the Commission to allow the adviser flexibility in its cash management.

Further, we suggest the Commission eliminate the requirement that short-term investments must have a remaining maturity of 60 days or less because legitimate business situations may arise where a fund would need to hold liquid positions for periods of longer than 60 days. For example, proceeds of a distribution may be held as reserves to cover potential indemnification or other clawback obligations that may extend for 12 or 18 months or longer dated instruments are more optimal for the fund and its investors; and, in such cases, the adviser should be permitted to invest those proceeds in liquid investments for a longer time period. It should be noted that investors in the venture capital fund are able to negotiate the parameters of permitted short-term investments of a venture capital fund when investing in the fund and have the ability to place an outside limit on length of maturities.

Finally, the Commission should expand its limitation on short-term investments in U.S. Treasuries to permit equivalent securities of foreign governments so that venture capital funds domiciled in a foreign jurisdiction can effectively manage their cash positions in an efficient manner.

b) Management Participation

Proposed rule 203(1)-1(a)(3) requires venture capital funds to offer to provide (and, if accepted, to provide) significant guidance and counsel concerning management, operations, or business objectives and policies to their qualifying portfolio companies. We ask the Commission to include some percentage of the fund's capital that is exempt from this managerial offer requirement to accommodate the varied ways in which transactions are structured. For example,

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[32] See Rule 3a-1 and 3c-5 of the 1940 Act.

to effectively spread the risk of an investment among various entities, many venture capital funds enter into group arrangements where one lead venture capital fund has the right to provide managerial assistance and the other venture capital funds may tag along and maintain a passive role with respect to the investment. With this in mind, we recommend the Commission use the venture capital operating company ("VCOC") qualifying requirements under the Department of Labor regulations with which many advisers to venture capital funds are already familiar.[33]

c) *Leverage*

While we generally agree with the Commission's approach in prohibiting a venture capital fund from leveraging its assets in excess of 15% of its aggregate capital contributions and uncalled committed capital,[34] we believe some exceptions should be built into the proposed rule or clarified in the relevant adopting release. For example, we have seen scenarios where a venture capital fund guarantees borrowings by a portfolio company on a nonrecourse basis when a lender requires security in the form of a pledge of assets of the portfolio company as well as a pledge of the equity ownership of the portfolio company. We do not believe such common arrangements should be limited by the 15% leverage provision in the current proposed rule.

We also believe that a venture capital fund should be permitted to borrow money in order to meet fee and expense obligations without counting towards the 15% borrowing limitation in order to continue operations when working capital may be low, particularly if the fund no longer has any uncalled commitments. Finally, we request that the Commission clarify that the limitation is based on indebtedness outstanding at any point in time. For example, amounts repaid in connection with borrowing for a particular portfolio company should be available to be re-borrowed for the next portfolio company without double-counting towards the 15% borrowing limitation.

d) *Redemption*

The definition of venture capital fund prohibits investors in the fund from having the right, except in extraordinary circumstances, to redeem from the fund.[35] We ask the Commission to clarify the scope and extent of the intended limitation on redemptions. While we appreciate the Commission's acknowledgement that a change in law affecting the fund or the investor would be

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[33] The regulations define a VCOC as any entity that, as of the date of the first investment (or other relevant time), has at least 50% of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, invested in venture capital investments. 29 CFR 2510.3–101(d). A venture capital investment is defined as ''an investment in an operating company (other than a venture capital operating company) as to which the investor has or obtains management rights'' that are ''contractual rights…to substantially participate in, or substantially influence the conduct of, the management of the operating company.'' 29 CFR 2510.3–101(d)(3).

[34] Proposed rule 202(l)-1(a)(4).

[35] Proposed rule 202(l)-1(a)(5).

an appropriate reason for redemption rights to be triggered,[36] we note that required redemptions are not always the result of changes in laws or enactment of new laws, but also failure to maintain the required status as a VCOC or other significant changes, events, or conditions affecting the fund or investors, investor defaults, and other extraordinary events or conditions. For example, if the venture capital fund intends to meet the VCOC standards under the Employment Retirement Income Security Act of 1974, as amended ("ERISA"), then investors should be permitted to redeem from the fund if such standards are not met, even though such a status change would not be the result of a change in law or the enactment of a new law.

We also ask the Commission to clarify that the prohibition on redemptions should be limited to circumstances whereby the venture capital fund is required to pay to redeem the interests of an investor; thus, forfeitures by an investor and transfers by an investor where assets of the fund are not being used to acquire the forfeited or transferred interest should be permitted subject to certain limitations under the partnership agreement (*e.g.*, general partner/adviser approval and securities laws considerations).

e) Minimum Investment Period

We agree with the Commission's initial position with regard to not imposing a minimum investment period for investors in a venture capital fund. If an extraordinary event occurs, the investor should be able to withdraw. Similarly, if an investor's financial circumstances change and the investor desires to transfer its interest or to be released from its commitment, the general partner or adviser should be allowed to exercise its discretion if it is willing to do so and allow a redemption, release, or transfer. Again, such a release or transfer does not require the payment to an investor of assets of the venture capital fund and such redemption would only occur in extraordinary circumstances.

f) Size of General Partner Investment

The Exemptions Release asks whether advisers to venture capital funds typically invest in the funds they manage, and whether such a characteristic should be incorporated into the definition of a venture capital fund. We believe that the size of general partner investments in a venture capital fund is best left to business negotiation between the general partner and investors in the fund. The existence and scope of a general partner investment in the venture capital fund is typically a topic of discussion in the formation of a fund and a point of negotiation by investors as they generally seek to have the general partner invest alongside with them in the fund or co-invest with the fund through other vehicles. The amount invested is a function of the size of the fund; and the amount of capital available to the adviser for investment, and the larger the size of the fund, the smaller the investment may be on a percentage basis (although larger in amount). Aside from negotiation with the general partner as to its investment level, we also note that new funds may be managed by persons that have not accumulated wealth from the success of prior funds and

[36] Exemptions Release, at 77203.

therefore they are constrained in the aggregate amount available to them to invest. However, the amount agreed upon with investors for their investment may still be material to their personal net worth and significant enough to comfort investors.

g) Minimum Term

We also agree with the Commission's initial approach to not impose a minimum term for the life of a venture capital fund. Although the ten-year period with one to three year extension is fairly common, there also are funds that have shorter terms. The setting of the term of the fund is a function of the amount of capital raised, the size of expected investments, and the nature of the fund, as well as general market conditions which will accelerate or retard the pace of investments and realization of those investments. In any event, if investments are made more quickly, then it is reasonable to expect that realizations will also happen more quickly and the venture capital fund will terminate earlier than the specified number of years. Additionally, arbitrarily imposed time periods could result in products not contemplated by the rule being tailored to fit the exemption.

h) Availability of Exemption to Foreign Funds and Advisers

We suggest that the Commission specifically allow foreign advisers that otherwise meet the components of the Venture Capital Fund Exemption to rely on the Venture Capital Fund Exemption when accessing the U.S. capital markets by either investing in U.S. companies or soliciting U.S. investors. Further non-U.S. advisers that manage funds that do not meet the definition of venture capital funds outside of the United States should still be able to rely on the Venture Capital Fund Exemption for funds that are managed in the United States or which are marketed to U.S. investors. Such specification would be consistent with the approach taken by the SEC with regard to the Private Fund Adviser Exemption as applied to non-U.S. advisers.

7. Participating Affiliate Doctrine

The participating affiliate doctrine, as expressed in various SEC no action letters, allows registered investment advisers to use resources, such as portfolio management personnel, of unregistered investment adviser affiliates without compelling the foreign affiliate to separately resign as an adviser in the United States ("Participating Affiliate Letters").[37]

The Participating Affiliate Letters have provided a pragmatic framework for large international investment management groups to comply with their registration obligations under the Advisers

[37] Most notably: *Royal Bank of Canada* (pub. avail. June 3, 1998) ("*RBC*"); *ABN AMRO Bank, N.V.* (pub. avail. Jul. 7, 1997); *Murray Johnstone Holdings Limited*, (pub. avail. Oct. 7, 1994); *Kleinwort Benson Investment Management Limited*, (pub. avail. Dec. 15, 1993); *Mercury Asset Management plc*, (pub. avail. Apr. 16, 1993); and *Uniao de Bancos de Brasileiros S.A.*, (pub. avail. Jul. 28, 1992) ("*Unibanco*").

Act without the additional costs of infrastructure and regulatory duplication. Its continuation should be endorsed by the SEC in the adopting release.

This approach would permit international asset management groups to structure their businesses in order to comply with both the U.S. and foreign legal regimes to which they are subject. Further, it would permit international firms to preserve existing business structures and would lessen the need for foreign advisers to simply abandon the U.S. market. This approach respects the efficacy of foreign regulatory regimes and limits the SEC's extraterritorial jurisdiction to the extent required to protect U.S. investors.

The Proposed Rules do not appear to anticipate a need to integrate separate advisory affiliates within a group; however, some industry observers have suggested that the Dodd-Frank Act would have just the opposite effect, setting the clock back to the days when integration was presumed absent compliance with the largely unworkable factors mandated by the *Richard Ellis Letter*.[38] We believe that the Proposed Rules do, and the final rules should, allow each advisory affiliate to examine its position, and determine its need to register (or file as an exempt reporting adviser), based on its facts and circumstances, rather than presuming that advisers who do not meet the stringent *Richard Ellis* conditions should be integrated or specifying any particular integration requirement.[39]

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38 *Richard Ellis* (pub. avail. Sept. 17, 1981) Under *Richard Ellis*, an advisory entity would avoid integration with its parent company where, the subsidiary: (1) is adequately capitalized; (2) has a board or similar governance buffer the majority of the members of which are independent of the parent; (3) has advisory personnel who are not engaged in the parent's advisory business; (4) makes investment decisions independently from the parent and does not rely solely on information provided by the parent; and (5) keeps its investment advice confidential until communicated with the client). We believe that the Commission's reference to *Richard Ellis* in the Exemptions Release is intended to establish a base presumption that advisers who are, in fact, separate as defined in *Richard Ellis* would clearly not be integrated, rather than to imply that advisers who fail to meet the Richard Ellis factors must be integrated. This result is consistent with the fact that, rather than withdraw *Richard Ellis* when issuing the Participating Affiliate Letters, the staff set forth the participating affiliate arrangement as an alternative to *Richard Ellis* separation. Thus, both lines of letters are, and should be confirmed to be, viable and available to global asset management groups. *See, also, Thompson Advisory Group L.P.* (pub. avail. Sept. 26, 1995) (noting that the Participating Affiliate Letters represent "an alternative approach to the regulation of foreign advisers to allow them greater flexibility than permitted under [*Richard*] *Ellis* in organizing U.S. registered subsidiaries. Foreign advisers may organize their operations in reliance on either [*Richard*] *Ellis* or this alternative approach, *based on their business needs*." [internal citations omitted and emphases added]). The staff has also, repeatedly, recognized that *Richard Ellis* separation may be inconsistent with beneficial information and resource sharing arrangements common to global asset management groups.

39 Footnote 271 of the Exemptions Release states plainly that "determinations [as to the extent to which prior staff positions apply] will depend on the particular facts and circumstances [and that a]dvisers should consider whether they may avail themselves of either [of] the exemption[s] proposed." Exemptions Release, at 77214.

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We believe this is the approach that is taken in the Proposed Rules and should be taken in the final rules. It is consistent with the Commission's expectations, as noted in footnote 271 of the Exemptions Release. By contrast, a return to the *Richard Ellis* conditions or any general presumption that integration of advisory affiliates, based merely on affiliation, is required would result in a manager's non-U.S. personnel, information and abilities no longer being available to U.S. persons, despite the proven track record of participating affiliate arrangements providing appropriate and reasonable protections to clients of the U.S. affiliate.[40] Perhaps most troubling, such an approach would require advisers to quickly unwind participating affiliate arrangements that have no history of abuse, have been recognized and relied on for substantial periods of time, and which are necessary to global advisers' ability to effectively and efficiently manage accounts and funds on behalf of U.S. investors and pensioners.

Affiliates within a global asset management group can easily be treated separately and in a manner that is consistent with the Participating Affiliate Letters. The Participating Affiliate Letters represented a workable solution to the increased interconnectivity among affiliated advisers and the desire to allow U.S. persons to benefit from the best minds that an organization has to offer.[41]

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40 In one of the more recent Participating Affiliate Letters, the staff recognized the general view that "the representations [associated with the Participating Affiliate relief] will provide the Commission with the necessary means to monitor the activities of the Participating Affiliates . . . with regard to the Registered Adviser's U.S. Clients, and police any conduct that may harm U.S. persons or markets." *RBC*.

41 In this respect it is worth reviewing the Staff's rationale for granting Participating Affiliate relief:

First, the Staff observed that: "[w]hile the *Richard Ellis* conditions have provided a framework that permits foreign advisers to offer advice to United States clients, many foreign advisers find it difficult to operate under these conditions. For example, foreign advisers often have been unwilling to dedicate their most senior personnel solely to a United States-registered subsidiary. United States clients therefore may find it difficult to gain access to the services of the adviser's most experienced employees." The Staff further explained that this caused the Division of Investment Management to reexamine "its interpretation of the reach of the Advisers Act [and] conclude that the policies and purposes of the Advisers Act, coupled with . . . the conduct and effects tests . . . lead to the conclusion that a more flexible approach is appropriate." In particular, this more flexible approach was intended to "allow non-United States advisers greater flexibility than permitted under *Richard Ellis* in organizing United States-registered subsidiaries."

Under the "more flexible approach", the staff would recognize the separateness of the registered adviser and its participating affiliate "if the affiliated companies are separately organized (*e.g.*, two distinct entities), the registered entity is staffed with personnel (whether physically located in the United States or abroad) who are capable of providing investment advice; all persons involved in United States advisory activities are deemed 'associated persons' of the registrant; and the Commission has adequate access to trading and other records of each affiliate involved in United States advisory activities, and to its personnel, to the extent necessary to monitor and police conduct that may harm United States clients or markets." *Unibanco*.

We also ask the Commission to consider extending the participating affiliate doctrine to domestic advisers. We believe there are numerous instances in which there are two or more affiliated domestic advisers which are under common control. Previously developed Commission protocol would require such advisers to be integrated for purposes of determining whether their aggregate AUM exceed relevant thresholds. However, it would be inefficient and burdensome, both for the staff of the Commission and for advisers, to be required to separately register each affiliate. We believe the principles which have been developed for foreign participating affiliates can be readily adopted to the domestic context without compromising investor protection. The staff has previously expressed some willingness to do so in recognizing that the general partner of a private fund need not register in circumstances in which the investment adviser to the fund is registered.[42] Registration should not be required where (i) there is at least one registered adviser in the group, (ii) the investment professionals of each participating affiliate are treated as advisory affiliates of the registered adviser, (iii) the operations of each affiliate are conducted in compliance with comprehensive policies adopted by the registered adviser and subject to supervision and monitoring by the chief compliance officer of the registered adviser, (iv) all books and records that would be required to be maintained if the affiliate were separately registered are maintained and are made available for inspection and examination by the SEC upon request, and (v) the registered adviser complies with relevant reporting requirements on an aggregate basis on behalf of each affiliate.

8. Pay to Play Rule

The Proposed Rules would amend rule 206(4)-5 (the "Pay to Play Rule") in a variety of ways as a result of the enactment of the Dodd-Frank Act. While we agree with the Commission's intent of amending the scope of the Pay to Play Rule to extend its application to certain exempt reporting advisers, we do not believe the Pay to Play Rule should be applicable to foreign exempt reporting advisers and advisers relying on the Foreign Private Adviser Exemption based on the extreme regulatory burdens associated with establishing and on-going implementing of an appropriate compliance program and the lack of corresponding benefits that will inure to the U.S. public as a result of such burdens.

Further, we note that the proposed changes to the Pay to Play Rule include a reference to a "municipal advisor" as defined in section 15B of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as a subset of advisors to whom an advisor or its covered associates may provide payment to in order to solicit a government entity for advisory services. We further note, however, that the definition of a "municipal advisor" does not include a person who solicits only on behalf of an affiliate. The Pay to Play Rule, as initially adopted, allowed affiliated broker-dealers or registered investment advisers to solicit on behalf of their affiliates without the need for additional registration or regulation. As revised, the Pay to Play Rule would seemingly require such entities to register under section 15B of the Exchange Act if it desires to maintain its status as a municipal advisor and subject affiliated solicitors to a regulatory scheme Congress previously determined unnecessary.

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[42] *See American Bar Association Section of Business Law* (pub. avail. Dec. 8, 2005)

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We thank you for the opportunity to comment on the Proposed Rules. If you have any questions about the foregoing comments, please do not hesitate to contact: Julien Bourgeois at 202.261.3451; Robert M. Friedman at 212.649.8735; George J. Mazin at 212.698.3570; M. Holland West at 212.698.3527; Michael L. Sherman at 202.261.3449; or Alpa Patel at 202.261.3346.

Sincerely,

Dechert LLP

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Kathleen L. Casey, Commissioner
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Jennifer B. McHugh, Acting Director, Division of Investment Management