January 13, 2011

VIA E-Mail

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

Re: *Release No. IA-3111; File No S7-37-10, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers (the Proposed Rules)*

Dear Ms. Murphy:

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) which, among other things, (i) amended the Investment Advisers Act of 1940 (Advisers Act) to eliminate the current exemption from registration for investment advisers with fewer than 15 clients and (ii) provided for a new exemption from registration for investment advisers solely to venture capital funds (VCF Exemption). The Dodd-Frank Act further required or authorized the Securities and Exchange Commission (the Commission) to adopt or revise certain rules applicable to investment advisers, including a rule defining "venture capital fund" (VCF). The Proposed Rules set forth this new definition.

The National Venture Capital Association (the NVCA)[1] is pleased to have the opportunity to comment on the Proposed Rules, with a specific focus on the Proposed Rules' impact on the venture capital industry. In particular, the NVCA's comments focus on the Commission's proposed definition of VCF for purposes of the new VCF Exemption.

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[1] The National Venture Capital Association (NVCA) represents more than 400 venture capital firms, comprising over 90% of all the venture capital under management in the United States. NVCA's mission is to foster the understanding of the importance of venture capital to the vitality of the U.S. and global economies, to stimulate the flow of equity capital to emerging growth companies by representing the public policy interests of the venture capital communities at all levels of government, to maintain high professional standards, and to provide research data and professional development for its members.

The NVCA appreciates the time, thought and effort of the Commission in formulating a VCF definition that reflects, in general, the types of activities and investments actually undertaken by venture capital funds. The NVCA does not have a significant number of comments to the Proposed Rules, but we believe adoption of the modifications we suggest will be critical to achieving a definition of the industry that will stand the test of time. It is important to note that the SEC's proposal, when finalized, will for the first time provide a common definition of the venture industry. Given the historic and ongoing contribution of venture capital investing to the US economy, the importance of correctly defining the industry goes beyond compliance with the strictures of the Dodd-Frank Act. This effort will, in many ways, determine whether the venture industry can continue as a critical lynchpin in the nation's entrepreneurial ecosystem, one that has been a unique competitive asset to this country. Over 12 million U.S. jobs and nearly 20% of U.S. GDP can be traced to companies that were originally venture backed. In this light, while recognizing the mandate to protect investors and prevent systemic risk, every aspect of the definition proposed by the Commission must be analyzed and scrutinized for its ultimate impact on the ability of the venture industry to continue to thrive.

We believe our comments and requests for clarification will provide (i) further alignment with the actual operations undertaken within the venture capital industry or (ii) heightened certainty that those operations will comply with the VCF definition. In either case, the NVCA believes this can be done without putting at risk the protection of VCF investors or increasing the possibility that a VCF will impose systemic risk on the financial markets.

The NVCA sets forth below a discussion of its primary comments and certain technical comments as well as responses to certain questions posed by the Commission in its request for comment to the extent not otherwise discussed. Almost all of the NVCA's comments reflect responses to the Commission's solicitation for comments on the various criteria for a VCF included in the Proposed Rules. As mentioned, our responses are intended to reflect further refinements to the Commission's understanding of the general operations of the venture capital industry as reflected in the Proposed Rules, to the extent that such refinements do not create additional risks to investor protection or the financial markets. They also clarify areas of ambiguity in order to provide certainty to the industry in applying the definition.

Primary Comments

Permissible non-qualifying investments or activity.

Our first comment is not in response to specific questions from the Commission but is, after extensive review, a modification that we believe is vital for the exemption and definition to function as Congress intended. Specifically, we believe the VCF Exemption should provide for a permissible level of non-qualifying activity, not to exceed 15% of a VCF's capital commitments.

Because of the consequence (*i.e.*, federal registration) of having even one inadvertent, non-qualifying investment, allowance for unintended or insignificant deviations, or differences in interpretations, is appropriate. Even though the Proposed Rules are generally consistent with existing venture capital industry practice, all VCFs will be involved in a significant behavior change in order to ensure compliance with the VCF Exemption's many requirements. This allowance would be an acknowledgement by the Commission of this situation.

By keeping this allowance at a low level in comparison with a VCF's overall operations and reasonably applied, this flexibility will allow innovation and job creation to flourish within the venture capital industry without a corresponding risk to VCF investors or the financial markets. It is also consistent with (i) rule 35d-1 under the Investment Company Act of 1940 which requires a mutual fund to invest at least 80% of its assets in the type of investment suggested by its name; (ii) current SEC Rule 508 which allows certain deviations from Regulation D requirements to the extent insignificant and (iii) VCF investor requirements which, while generally requiring VCFs to invest only in venture-backed companies, typically allow the VCF the flexibility to use some amount of capital for other types of investments.

For example, under the current Proposed Rules, a VCF must own solely equity securities of qualified portfolio companies (QPCs), cash or cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less. It is possible, however, that a VCF may prepay expenses. While we do not believe that such an asset is "owned" by the VCF for this purpose, whether the Commission may view a technical accounting standard asset as "owned" creates uncertainty even though such asset would be innocuous. Or, a VCF may inadvertently hold cash in a U.S. Treasury with a remaining maturity of 90 days.

Further, since some criteria involve portfolio company activity over which a VCF is unlikely to have control, such flexibility is essential. For example, under the current Proposed Rules, a QPC must not borrow, redeem, exchange or repurchase securities, or distribute assets to security holders "in connection with" a VCF's investment in that QPC. If the language "in connection with" is not clarified to ensure it falls within the control of the VCF (as requested below), then it is possible that a QPC may engage in activities without a VCF's input and cause the VCF to unwittingly run afoul of the QPC definition.

Such an allowance would also acknowledge that industry practices (i) include, or may evolve to include, more effective or efficient ways of accomplishing the same economic result, but in a different form than permitted under the Proposed Rules, or (ii) need to take into account unforeseen economic conditions. For example, in challenging markets, a QPC investment might need to be supported through a "down-round" in order to protect the VCF's investors, which might involve a prohibited exchange of QPC securities due to a change in the securities' priorities. Alternatively, it might be necessary for a VCF to guarantee a portfolio company's permissible debt in order for the portfolio company to achieve better terms and conditions. This would be prohibited if the guarantee exceeded 120 days even though, were the guarantee to be called, the amount would most likely be viewed as a permissible QPC equity security investment.

While the NVCA believes that there may be legitimate uses for the allowance in all areas of the definition's requirements, there are two instances in which we believe there may be flexibility in its application. First, we understand that the fund borrowing component may be viewed as most susceptible to abuse. If the Commission feels strongly that non-VCFs may be able to fall within the VCF definition if fund borrowing levels were able to be increased due to the 15% allowance, such fund borrowing activity could be excluded from the allowance. In addition, a VCF's inadvertent misstep in connection with the "representation as a venture capital fund" and "offer of managerial assistance or control" criteria of the VCF definition may be more conducive to a cure provision than to inclusion in the 15% allowance.

QPC borrowing limits.

> *SEC: Should we provide guidance on other [see below] types of financing transactions as being "in connection with" a fund's investment in a qualifying portfolio company? Should we use a test other than whether the loan is "in connection with" the fund's investment? 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?*

The interests of the Commission and venture capital industry are aligned in reaching a workable limitation on QPC leverage as a condition to VCF status. VCFs do not leverage acquisitions of their portfolio companies. While the vagueness of the currently proposed language may cause technical uncertainty regarding conformance with the VCF definition, the NVCA views two alternatives as acceptable restrictions on the borrowing activities of a QPC in which a VCF invests, while preserving the Commission's intent.

The Commission stated in the commentary to the Proposed Rules that borrowing in the ordinary course of business (*e.g.*, to finance inventory or capital equipment, manage cash flows, and meet payroll) would be permissible QPC borrowing. It is possible, however, that a VCF may not know whether a company is borrowing in the "ordinary course" if it borrows for reasons other than those provided in the example. Because certainty is required and company operations should not be impaired, it is necessary that borrowing and paying down debt in what the company views as the "ordinary course" not be affected by this rule.

In that regard, it would be rare for a VCF portfolio company (unlike a portfolio company that engages in a leveraged acquisition financing transaction) to borrow to make distributions to the VCF or to buy out its shareholders. As a result, the NVCA believes it would be appropriate to restrict private funds from qualifying as VCFs if they invest in QPCs that borrow, where the proceeds of such borrowing are required by the private fund to be used to buy out shareholder stock or return capital to the fund. While it would not be the intent of a VCF to make an investment in a QPC that borrowed funds to engage in any buyout activity, a VCF would not be able to prevent a QPC (which it is unlikely to control) from doing so – especially later in its life and especially if that QPC were later to become a public company. As a result, if this "use of proceeds" criterion were used instead of the "in connection with" criterion provided in the Proposed Rules (as discussed below), it would only be appropriate if the VCF itself required the QPC to engage in the prohibited use of proceeds. In any other case, the prohibited use of proceeds by the QPC would not be within the control of the VCF.

Alternatively, if the current language of the Proposed Regulations is retained (either alone or in conjunction with the language set forth above), additional protections would be required in order to provide a VCF with sufficient guidance regarding, and control over, the restrictions imposed on its QPCs. As mentioned, a VCF typically does not exert control over its portfolio companies so it would not be able to direct a portfolio company in all instances to operate in a manner so as to be a QPC.

The Commission stated in the commentary to the Proposed Rules that it "would generally view any financing or loan (unless it met the definition of equity security) to a portfolio company that was provided by, or was a condition of a contractual obligation with, a fund or its adviser as part of the fund's investments as being a type of financing that is 'in connection with' the fund's investment, although we recognize that other types of financings may also be 'in connection with' a fund's investment." We are uncertain what other types of financings may be implicated by the "in connection with" language and are concerned that such financings would be outside of the control of the VCF to prohibit. If, however, it were clarified that QPC borrowing is treated as "in connection with" a VCF investment only if (i) the loan were extended to the QPC by the VCF or (ii) the QPC borrowing were a condition of a contractual obligation of the VCF, then this would provide the certainty and control necessary for a VCF to ensure that a QPC's ordinary borrowing activities do not cause a fund to fail to qualify as a VCF.

It is our understanding that funds which engage in leveraged acquisitions, which may give rise to systemic risk concerns, typically include such contractual debt obligations and/or use of proceeds provisions in their acquisition documents.

Secondary transactions.

> *SEC: Is our assumption that venture capital funds do not generally acquire portfolio company securities directly from existing shareholders correct? Is 80 percent the appropriate threshold? Should the threshold be set lower? 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?*

The NVCA agrees that VCFs typically do not acquire portfolio company securities from existing shareholders. Because of the varying nature of founder/angel participation in different types of venture-backed companies, however, the NVCA believes that the 20% secondary acquisition limitation should apply to the VCF as a whole (rather than on a company-by-company basis). This would mean that up to 20% of the VCF's capital commitments could be used to acquire stock from existing investors of the VCF's various portfolio companies.

In order to prevent abuses by multi-strategy funds (*e.g.*, hedge funds with illiquid "side pockets"), the current 20% limit on acquisitions of existing shareholder stock – applied on a company-by-company basis – could remain, but should be increased to 50% to the extent such excess is attributable to the purchase of common stock issued by the company to current or former employees and service providers to the company.

By limiting the increased threshold to the acquisition of service provider stock, we believe that financial markets would not be systemically affected by the increased liquidity that may be provided to that limited group of shareholders. By further limiting the increased threshold to common stock, we distinguish a venture capital transaction from a financing transaction that might be undertaken by a private equity fund. We believe that this prevents the buyout of a financial investor and eliminates a potential workaround by having such financial investor (who would typically invest in preferred stock) declared a "service provider" to the company.

This flexibility is primarily needed in the internet and social media industries where it is often necessary to acquire stock from the existing founders and other service providers who have built the company's initial technology using their own limited resources. The partial acquisition of their stock allows them to be recompensed for their initial efforts (which they may have undertaken with little or no pay) and brings them into alignment with the VCF and its investors who still expect to take the typical seven to ten years to build a viable stand-alone company.

As a technical matter, we assume that a simultaneous equity financing and shareholder stock acquisition would be aggregated for purposes of applying the secondary transaction percentage limitations, and request confirmation to avoid any uncertainty.

> *SEC: Rather than define a VCF by reference to 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? For example, should the rule specify that proceeds of… financings not be used to finance the acquisition of equity securities by a VCF or otherwise distribute company assets to equity owners? Are there other capital reorganizations [other than those intended to simplify the company's capital structure without changing the existing beneficial owners' rights, priority, or economic terms] that would be consistent with the intent of our proposed rule but that would prevent a VCF from satisfying the proposed definition?*

Under the Proposed Rules, a QPC is not permitted to redeem investors in connection with a VCF investment, yet a VCF can directly acquire stock of existing investors subject to the limitations described above. In practice, it is common for a VCF to fund a portfolio company which will then, in turn, redeem certain of its existing investors such as founders or other service providers. This enables the VCF to acquire preferred stock rather than the common stock of a founder or service provider. Although the Commission's commentary indicated that stock conversions are permissible, it also says that a conversion that results in a change in priority (presumably, even where the preferred stock may be "participating preferred") would not qualify although we believe that it should qualify in the situation described above.

Given that the end result of a direct versus indirect secondary stock acquisition is similar, we do not believe that increased systemic risk or investor protection risk is implicated. As a result, the NVCA urges the Commission to apply the limitations described above on a combined basis, to both direct and indirect acquisitions (*i.e.*, an original issuance of stock by the company in conjunction with a redemption of shareholder stock by the company).

The NVCA notes the Commission's reference to Internal Revenue Code ("Code") section 1202's "qualified small business stock" (QSBS) definition saying "[w]e adopted this 80 percent threshold because we understand that many venture capital funds currently are managed in a manner that seeks to rely on provisions of the tax code providing favorable tax treatment for directly acquired equity securities of issuers that satisfy certain conditions." It goes on to say *"[t]hus, using this threshold in our definition may not result in substantial changes to either investment strategies employed or the compliance programs currently used by venture capital advisers*" (emphasis added).

The NVCA believes, however, that the QSBS rules are not an appropriate comparison for purposes of the VCF Exemption, although we note that Code section 1202 does permit limited indirect buyouts. Code section 1202 requires that QSBS be originally issued stock, but it allows redemptions of up to 5% of an unrelated shareholder's stock for a year before and after the original issuance, and permits such redemptions in unlimited amounts outside of that 2-year period. For purposes of comparability, however, the 80% test in the QSBS definition applies to all of the company's assets while the Commission's 80% test only applies to the amount invested by the particular VCF in the company.

More important, VCFs typically do not base their investment strategies on compliance with Code section 1202 for several reasons, so this Code section should not be relied upon as an indicator of practice in the venture capital industry. First, most VCF investors are tax-exempt or non-U.S. or U.S. corporate taxpayers, none of whom benefit from the exclusion. While the exclusion applies only to U.S. individual taxpayers, it also is severely limited in its use by individual venture capitalists (*e.g.*, individuals associated with the investment adviser) who receive so-called "carried interest". Finally, due to an anomaly in tax rates, the QSBS tax rate benefit for many years has been limited to approximately 0.2%.

Public company investments.

> *SEC: We … request comment on our approach to "follow-on" investments. Would our proposed approach to follow-on investments accommodate the way venture capital funds typically invest? Are there circumstances in which a venture capital fund would provide follow-on investments in a company that has become public? 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)? If so, what is the appropriate percentage threshold?*

The NVCA believes that follow-on investments in portfolio companies after they become public companies should qualify as permissible fund investments provided the VCF continues to hold at least a majority of its original investments made earlier in privately acquired equity securities.

In certain cases, an initial public offering (IPO) functions as an additional financing round wherein the capital raised goes into the company to further finance its operations and expansion. This is especially true in the life sciences industry because the companies are capital-intensive, take many years to reach viability and are milestone-driven based on clinical trial passage. It often can take two years or longer after such a company goes public before it becomes cash-flow positive (although we would resist arbitrary timing rules that might provide skewed incentives). It is estimated that over 70% of biotech IPOs in 2010 were venture-backed companies that have required private investor participation, including companies such as Alimera Sciences and Zogenix.

Because these public company investments would be limited to those in which the VCF already holds privately acquired equity securities (or in exchange for such privately acquired equity securities), and based on the limited life of a VCF, investor protection and systemic risk concerns should not be implicated by such investments.

Technical Comments

Exit opportunities.

It is possible that a VCF's exit opportunity might be cast in the form of a non-qualifying investment. VCFs generally realize returns on their company holdings (i) when the company is taken public and those public company shares can be sold or distributed to investors or (ii) when the company is acquired.

In certain cases, an acquiring company engages in a stock-for-stock exchange, asset sale or other type of merger and acquisition transaction with the QPC's shareholders as a method of structuring the liquidity event for the VCF and its investors. Often such stock consideration is accompanied by cash consideration to the VCF. While the intent is to provide liquidity for the VCF and its investors by selling or distributing the acquiring company stock, before that can occur, the acquiring company stock likely will not qualify as a permissible fund investment. First, the acquiring company stock may not qualify as a QPC since it may be public or it may not satisfy the borrowing restrictions or the stock redemption, repurchase, exchange or distribution restrictions applicable to QPCs. Furthermore, the VCF may be unlikely to satisfy even the requisite offer of managerial assistance. In fact, it would not be likely for (nor the intent of) the VCF to have control over the acquirer or to engage in VCF type activities with respect to the operations of the acquirer.

The NVCA believes that consideration received from an acquiring company in the form of acquiring company stock in a bona fide acquisition intended to provide liquidity to VCFs and their investors should not disqualify a private fund from VCF status.

Representation as a venture capital fund.

SEC: We request comment on this grandfathering provision.

For purposes of the Proposed Rules' grandfathering proposal, the NVCA believes that the evolving industry terminology should be acknowledged and clarified as permissible. Examples of such include: (i) venture capital as a sub-set of private equity, (ii) multi-strategy to refer to sector, stage and/or geographic diversification, and (iii) growth capital or growth equity to refer to late-stage venture capital investing.

Over the past 15 – 20 years, the broad terminology of "private equity" has been used to refer to various segments of "alternative assets", which would include "venture capital" (as well as "buyout") as a subset thereof. As a result, many older venture capital funds' offering documents and presentations to potential investors may have used the term "private equity". While the Commission's commentary indicates that funds holding themselves out as "private equity funds" are not expected to qualify under the grandfathering provision, the NVCA believes that prior use of the term "private equity" should not, in and of itself, be disqualifying for these older funds.

Further, we agree that the use of the term "multi-strategy" should be disqualifying to the extent that it refers to a combination of a venture capital strategy with buyout or hedge fund strategies. Prior use, however of the term "multi-strategy" should not be *per se* disqualifying as it often referred to stage (e.g., early-stage or late-stage venture capital), sector (e.g., IT, life sciences, energy), or geography (e.g., U.S., Western Europe, Asia).. Further, late-stage venture capital investing has typically been referred to as "growth equity" or "growth capital" which should not be a disqualifying descriptor of a venture capital fund.

We do not believe that any further changes to the grandfathering proposal are necessary or appropriate and do not believe that this criterion, as it exists for new funds, presents problems to the industry.

Bridge loans.

> *SEC: 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? 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? Should we modify the proposed rule so that such investments and loans could be made subject to a limit?*

The NVCA believes that non-convertible bridge loans to portfolio companies that are of a limited duration should qualify as permissible fund investments. In particular, such permissible non-convertible bridge loans should be limited to loans that have a maturity of 180 days or less, with up to one 180-day rollover period.

Such bridge loans are often needed, from a business perspective, to allow a portfolio company to meet its expenses before the terms of a new round of financing can be agreed upon. These bridge loans are not always automatically convertible into equity – if they were, we understand they would qualify as "equity securities". However non-convertible loans may be used in order to (a) incentivize the portfolio company and any new equity investors to close a financing in a timely fashion and (b) retain some negotiating leverage with any existing VCF over the terms of the new equity series. Non-convertible bridge loans are also used when a QPC is in the process of selling itself to a strategic buyer. The loan allows for completion of the sale and is expected to be repaid from the sale proceeds.

These types of short-term non-convertible bridge loans are not used to execute leveraged financing transactions which might cause systemic risk to the financial system, nor do they put VCF investors at risk.

For consistency across the various VCF definitional requirements, if such limited short-term bridge financing is permissible, additional changes must be made in order to allow a QPC (i) to borrow from a VCF for such purpose even if such bridge loan were viewed as being "in connection with" the VCF's investment in the company and (ii) to pay off the bridge loan in connection with a VCF equity investment in the company (since otherwise such payment may be considered a "distribution to a pre-existing security holder").

Short-term investments.

> <u>SEC: *We define "cash and cash equivalents" by reference to rule 2a51-1(b)(7)(i) under the Investment Company Act which includes foreign currencies and bank deposits, certificates of deposit, bankers acceptances and similar bank instruments, and – since that rule does not explicitly include short-term U.S. Treasuries – our rule would include short-term U.S. Treasuries with a remaining maturity of 60 days or less. Should we specify a shorter or longer period of remaining maturity for U.S. Treasuries? We request comment on whether the proposed rule's provision for cash holdings is too broad or too narrow. 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? Are there other types of cash instruments in which venture capital funds typically invest and/or that should be reflected in the proposed rule?*</u>

The NVCA believes that the types of permissible short-term investments – cash and cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less – should be expanded to include any safe short-term investment. These short-term investments are often made between the time that capital is drawn from fund investors and before the QPC investment is documented and finally funded. There are many short-term investments in which VCFs invest that, while being safe investments, may provide a better return for the VCF investors than the limited instruments set forth in rule 2a51-1(b)(7)(i) of the Investment Company Act. For example, VCFs often invest in federal agency securities, repurchase agreements, money market mutual funds and deposit accounts, and mutual funds that invest principally in such securities and/or U.S. Treasuries. Provided that a VCF must represent itself as a venture capital fund, we do not believe that expanding the list of permissible short-term investments to include such instruments could be abused by funds organized to trade in such instruments.

Limits on QPC redemptions, exchanges, repurchases and distributions.

> <u>SEC: *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? Rather than define a VCF 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?*</u>

The NVCA believes that the language of the Proposed Regulations should be clarified so that QPC redemptions, exchanges, repurchases or distributions are "in connection with" a VCF investment only if such QPC action was a condition of a contractual obligation of the VCF. In addition, the exchange/conversion by a VCF of a permissible bridge note should be expressly permitted.

Similar to the QPC borrowing limitations, there is little certainty in the phrase "in connection with" as it is used here. For example, if distributions out of VCF investment proceeds to a pre-existing lender were required – by that lender – to be paid out of an equity financing, those distributions should not cause the portfolio company to not meet the QPC definition. Even if the original borrowing were made by the QPC in the ordinary course of business, it is unclear whether the distribution to the lender would be permissible, but we believe that it should be permissible (even if the lender is also an equity holder in the QPC). The appropriate use of third-party debt in the operations of a portfolio company's business should not be restricted by the VCF definition.

Clarity would be achieved if this criterion were within the VCF's control so that the portfolio company's activity would only disqualify it as a QPC if the VCF required such company activity as a condition to such VCF's investment. Permissible secondary stock acquisitions and exchanges/conversions of bridge loans (as requested above) should not be subject to this provision.

Private funds and other pooled investment vehicles.

> *SEC: The Proposed Rules would define the term QPC for the purposes of the exemption to exclude any private fund or other pooled investment vehicle. We request comment on this definitional element.*

The Commission notes that there is no indication that Congress intended the venture capital exemption to apply to funds of funds. Without this definition, a VCF could circumvent the intended scope of the exemption by investing in other pooled investment vehicles that are not themselves subject to the definitional criteria under the Proposed Rules. The NVCA is sympathetic to this concern and agrees that such investments would unacceptably heighten the possibility for abuse.

The venture capital industry, however, does use intermediate holding vehicles for structuring its investors' holdings in its funds and, in turn, its portfolio companies for legal, tax or regulatory reasons. For example, tax-exempt institutional investors and non-U.S. investors typically seek to avoid investments in tax-transparent operating companies in order to minimize taxation attributable to "unrelated business taxable income" (UBTI) and income "effectively connected with a U.S. trade or business" (ECI), respectively. At the same time, U.S. taxable investors may prefer such a form of investment due to U.S. tax efficiencies. Alternatively, investments may be made through holding companies in different jurisdictions for more tax-efficient returns.

This may mean setting up separate structures, typically known as "alternative investment vehicles," that are themselves private funds. These entities may invest in parallel with the VCF, invest as a limited partner into the VCF or be an entity through which the VCF invests into a QPC.

In all cases, however, each entity in the chain of ownership through to the underlying portfolio company would qualify as a VCF.

The NVCA believes that a VCF that invests in a private fund or holding company that, in turn, qualifies as a VCF should be permitted. We understand that the Commission has put significant thought into ensuring that the scope of the VCF Exemption is not expanded while continuing to allow the normal business practices of the venture capital industry to continue. The NVCA does not intend this recommendation to expand the scope of the exemption because all entities in the chain of ownership would be subject to the definitional criteria under the Proposed Rules. To prevent abuse that may result from the potential for duplicate "15% allowances" for non-qualifying investments or activity (as requested above), the top-tier entities (*i.e.*, entities further from the portfolio company) could be required to reduce their allowance by their pro rata share of any allowance used by an underlying VCF. We also suggest that VCFs that invest in parallel be similarly aggregated for such "15% allowance" purposes.

Responses to Other Specific Questions in Request for Comment

The NVCA here also responds to certain other of the Commission's questions in its request for comment, to the extent those questions have not already been addressed. The NVCA's responses primarily affirm the approach taken by the Commission in each such case.

Equity Securities.

> *SEC: Should we consider a more limited definition of "equity security"? Do venture capital funds typically invest in other types of equity securities that are not covered by the proposed definition?*

The NVCA agrees with the Commission that a more limited definition of "equity security" is unnecessary. Because, however, the definition of "equity security" in section 3(a)(11) of the Securities Exchange Act of 1934, which is used in the Proposed Rules, does not specifically refer to interests in limited liability companies (although we assume they are included), we request that the Commission confirm that such interests, like limited partnership interests, qualify.

Non-U.S. Investments.

> *SEC: Should our proposed definition … 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)? 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…?*

The NVCA agrees that VCFs should be permitted to form as, and invest in, non-U.S. entities. VCFs themselves typically are organized as Delaware limited partnerships. They may, however, organize themselves as non-U.S. partnerships primarily due to non-abusive tax considerations or the regulatory concerns of international investors. In either case, U.S.-based investment advisers to these funds are fully subject to U.S. securities laws if they operate out of the U.S.

Due to increased globalization in recent years, and concerns over competitiveness of U.S. companies, it is important that VCFs be permitted to invest in companies worldwide. VCF portfolio companies are increasingly global and many companies that may have been founded outside the U.S. will also have significant U.S. operations to take advantage of the U.S. market for customers, capital, products or talent. Examples include Checkpoint Software (founded in Israel with significant U.S. operations and an acquirer of numerous U.S. companies including ZoneLabs) and ScanSafe (founded in the UK and acquired by Cisco).

Because the types of investment strategies that VCFs employ are generally replicated outside of the U.S., increased systemic risk, if any, is not significant.

Limits on Public Company Holdings.

> *SEC: 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 securities. Should the rule specify that publicly traded securities may only be held for a limited period of time … or that a venture capital fund's entire portfolio may not consist only of publicly traded securities except for a limited period of time…?*

The NVCA agrees with the Commission that a VCF's public company holdings that are permissible under the Proposed Rules – *e.g.*, privately acquired securities of companies that subsequently become public companies or follow-on investments in such public companies (as requested above) – should not be limited in terms of time or amount.

Because a VCF invests in a limited number of companies during a finite period of time, and because a VCF generally has a 10-year term plus a liquidation period, certain limits on the amount and time for holding public company securities are built into the structure of a VCF. If, however, artificial constraints are imposed that do not allow for an orderly liquidation of the VCF's companies through the exercise of the investment adviser's business judgment, VCF investors' returns will suffer.

For example, lock-up periods generally provide that a VCF is not permitted to distribute or liquidate portfolio company shares for some period of time after a public offering. These lock-up periods may extend past 180 days, but even the lapse of a lock-up period does not always result in the most opportune time for the fund to divest itself of its company shares. Secondary market sales of issuer shares soon after expiration of a lock-up is often inadvisable due to market reaction. If public company stock needs to be sold too soon or in too great amounts, downward price pressure may result.

Managerial Assistance and Control.

> *SEC: We request comment on the description of managerial assistance in [the Proposed Rules]. Is this description easier to understand and apply than the definition in…the Investment Company Act? Should the rule specify that the fund or its adviser actually provide assistance? 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 exercise supervision or influence over the operation or business of the operating company? Does the fact that the assistance need only be offered render the condition so readily met that the criterion should be removed from the rule? Should the rule specify that in all cases managerial assistance includes both the offer of assistance as well as the exercise of control? 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?*

The NVCA agrees that the offer-only proposal set forth in the Proposed Rules is appropriate, rather than requiring that managerial assistance actually be provided or that control actually be acquired. Because each of a VCF's companies has different needs over time based on stage, personnel and skill sets, more definitive requirements for VCF assistance are not appropriate or necessary. For the same reason, numerical investment or ownership tests and any control requirement should be avoided – especially since VCFs typically do not reach the ownership thresholds necessary to exercise control in the manner often required by private equity funds.

The NVCA assumes, and requests confirmation, that a "management rights" letter received by a VCF from a portfolio company for purposes of the "venture capital operating company" (VCOC) rules under ERISA would qualify as an offer of managerial assistance. Because compliance with the VCOC rules can entail significant analysis by a VCF, providing this confirmation will not only provide certainty to VCFs that this criterion is satisfied with respect to many, though not all, of their portfolio companies, it will also prevent unnecessary duplication of effort and expense on both the VCF and QPC.

VCF Borrowing.

> *SEC: Do venture capital funds use lines of credit repeatedly but pay the outstanding amounts in full before drawing down additional credit? Should loans of this nature be included in the definition? 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? Would the 120-day limit alone achieve a similar result? Should the 15 percent calculation be determined with respect to the total investment amount for each portfolio company?*

The NVCA agrees that it is appropriate to limit a VCF's borrowing to 15% of the VCF's capital contributions plus undrawn commitments, for a 120-day non-renewable term.

VCFs typically use lines of credit to make portfolio investments, pending the receipt of capital called down from its investors, and pay the outstanding amounts in full before drawing down additional credit. If such borrowings were included in the limits set forth above, it is unlikely that a VCF's round of financing would exceed the 15% amount limitation since investments in any single portfolio company are usually limited in size based on aggregate commitments. Furthermore, drawdown periods rarely exceed 120 days. The NVCA agrees, however, that it is unnecessary to include such borrowings in the limitations set forth above since they do not implicate investor protection or systemic risk concerns. The NVCA further assumes that subsequent drawings on a line of credit after earlier drawings are paid off would not be considered a violation of the 120-day non-renewable term requirement, but confirmation by the Commission would provide certainty on this issue.

The 15% limit should not be based on the amount invested in a QPC, however, since as mentioned above, a VCF's borrowing usually occurs to invest in a particular QPC and is repaid (in total) out of drawn down capital from the VCF investors.

VCF Redemptions.

> *SEC: Is the phrase "extraordinary circumstances" sufficiently clear to distinguish the investor liquidity terms of VCFs, as they operate today, from hedge funds? Should the rule define when withdrawals by investors would be "extraordinary"? Should the rule specify minimum investment periods for investors? Could venture capital funds provide investors with "extraordinary" rights to redeem that could effectively result in redemption rights in the ordinary course? Should we address this potential for circumvention of the definition by establishing a maximum amount that may be redeemed during any period of time? Would such a limit constrain investors in a way so as to prevent them from complying with other legal or regulatory requirements?*

The NVCA agrees that VCF investors should be permitted redemption rights only in extraordinary circumstances, usually based on legal, tax or regulatory restrictions (most commonly, under ERISA) or written investor policies.

The NVCA does not believe that there should be a minimum period of time before even extraordinary redemptions may be permitted since the extraordinary event is generally not controllable by the investor and, if a strict lock-up period were required, it would result in non-compliance by that investor.

The NVCA also does not believe, as implied by footnote 154 of the Commission's release, that a general partner's consistent consent to transfers of interests may be tantamount to a redemption right. Even if a general partner typically consents to transfers, such transfer requests often are unrelated to providing liquidity to the investor. For example, it would be quite unfavorable to VCF investors if they were not able to transfer their interests, including to affiliates in the case of restructurings, bankruptcies, portfolio allocations, etc.

Furthermore, any such transfers are limited in ways that prevent the interests from being tradable in a manner comparable to a public market. For example, general partners often require that transfers are grouped on certain dates for reporting purposes, or are held for up to 12 months for tax purposes. Further, general partners will examine the nature and characteristics of any transferee prior to giving consent in order to quell concerns over credit worthiness, competition and compliance with legal opinion requirements.

As a technical matter, the Proposed Rules specify that a VCF may only issue securities with terms that do not permit redemption except in extraordinary circumstances, "but may entitle holders to receive distributions made to all holders *pro rata*." The NVCA assumes that the Commission did not intend to restrict the ability of the VCF's general partner to receive its "carried interest" distributions which typically equal 20% of the VCF's cumulative net profits. While the commentary to the Proposed Rules indicated that the *pro rata* distributions are to be made to all investors which might only imply limited partners, in certain cases, carried interest is received by an entity that holds a limited partner (rather than general partner) interest in the VCF. The NVCA believes that this fundamental term of a VCF's arrangements should not be implicated by the Proposed Rules.

Other Factors.

SEC: Should other criteria be included?

The Commission asks whether certain other criteria should be included in the VCF definition.

The NVCA agrees that an adviser capital commitment would not be a significant differentiator between venture capital funds and private equity or hedge funds and should not be included. More important, it would be difficult to set a requisite amount for an adviser commitment. The amount of adviser commitments varies widely from VCF to VCF. Especially for first-time funds, the amount might even be lower than 1%, if it represents a significant portion of the individuals' net worths. This is a term that is highly negotiated between the VCF's adviser and investors and is specific to the individuals and context. The NVCA believes that any such amount is best determined by the VCF's investors.

The NVCA further believes that a definition of "retail investor" is unnecessary given the current investor requirements for VCFs to be excluded from the definition of "investment company" under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940. Testimony provided by NVCA members referring to "retail investors" was meant to refer to investors not meeting the Investment Company Act of 1940 requirements.

The NVCA, however, has no objection to requiring that a VCF have a minimum term of 10 years. Similarly, a related feature which distinguishes VCFs from many hedge funds, and which the Commission could consider, is that hedge funds typically are open-ended funds and VCFs are closed-ended, limited-term, funds.

<u>Conclusion</u>

We believe that the VCF definition in the Proposed Rules as developed thus far reflects a well-defined understanding of the general operations of the venture capital industry. The definition's requirements highlight that the venture capital industry operates in a manner that provides protection to its investors and imposes no systemic risk on the financial markets and that registration, as a result, would be an unnecessary and expensive burden to place on a small industry that spurs job creation, supports innovation and promotes economic growth for the nation.

Under the Proposed Rules, however, there is risk that some VCFs may feel obligated to register as investment advisers due to restrictions that preclude variations on these typical operations, even if these variations impose no additional risk to investors or the financial system. Others may register upon advice that the rules do not provide sufficient certainty that their operations comply with the definition's requirements, even if the intent of the Commission is that such operations would comply. It would be an extremely unfortunate result if investment advisers to VCFs felt compelled to register because their funds failed to meet the definition of a VCF due to innocuous activities or uncertainty, particularly when these funds do not put investors or the financial system at risk.

Perhaps most critically, without some measured degree of flexibility and certainty in the VCF definition, the exemption for investment advisers to VCFs may be rendered meaningless. This result would neither protect the sophisticated institutional investors who have supported the current venture capital model for over 35 years nor would it enhance the stability of the financial markets. Rather, it would stifle innovation, economic growth and job creation at a time when Congress recognized the power of the venture capital industry to promote such goals.

We urge the Commission to consider our comments carefully, and we would be pleased to provide further input. Please do not hesitate to contact me or the NVCA's Vice-President of Federal Policy, Jennifer Dowling, at 703-524-2549.

Sincerely yours,

Mark G. Heesen
President