January 21, 2011

<u>VIA E-Mail</u>

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:

Thank you for the opportunity to submit comments regarding the SEC's proposed "venture capital fund" definition ("VC Fund") in connection with the rules that would implement new exemptions from the registration requirements of the Investment Advisers Act of 1940, enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

<u>Summary</u>

These comments are submitted on behalf of Charles River Ventures ("CRV"), one of the nation's oldest traditional venture capital firms, this year entering its fifth decade of operations. We invest in early-stage technology companies. Under the current formulation of the SEC's rules, we would not be considered a "VC Fund," as defined. We almost always syndicate with other top tier "brand name" VC firms and hence are familiar with their deal structures at least insofar as we are in the same investments with them. Thus we are also certain that we would be the norm, and not the exception, in failing to qualify as a "VC Fund." And that simply can't be right – or, should not be right. That said, we think we run afoul of the current *letter* of the draft regulations, but not their spirit. If the rules are revised to permit a consistent (for easy application) modicum of flexibility – in order to prevent mere foot-faults from turning into game-ejecting fouls – typical venture firms like ours would remain eligible, as the SEC clearly intends, for the "VC Fund" exemption. The rules should not bar the occasional, but also quite ordinary, financial activities of a venture firm, as we will describe in more detail below with recent examples from CRV's own operations.

<u>Background on Our Firm</u>

CRV has an office in Menlo Park, CA and one in Waltham, MA. As is typical for an early-stage venture capital firm, our headcount is very small. We have 29 employees in total, of whom nine are investing partners and the balance fill administrative support roles. Our funds, which have been among the highest performing in the industry, invest primarily in information-technology related companies (we do not invest in life sciences). CRV's core strategy is to invest in seed, start-up, and other early-stage projects with an emphasis on significant equity ownership. Over the lifetime of a project, we typically expect to invest $5 to $15 million and own a significant, but non-controlling, interest in the company, in the 15% to 30% range. However, for certain companies that show great potential, we may commit more capital to maintain our ownership even at higher valuations.

Among the portfolio of companies that we have funded at a very early stage are Cascade Communications, CIENA, Chipcom, EqualLogic, Flarion Technologies, Netezza, Parametric Technology, Sonus Networks, SpeechWorks International, Stratus Computer, Sybase and Vignette. Our goal is to build companies that will enjoy long-term, sustainable growth. Over our four decades in business, the companies we have invested in have added over a hundred thousand jobs to the American economy.

We are currently investing out of our 14^{th} fund, which has approximately $320 million in capital commitments. Since inception, across all of our core funds, we have raised an aggregate of approximately two billion dollars, and invested in nearly 400 companies. We pride ourselves on playing an important leadership role in our investments, and have Board seats at most of our portfolio companies ("PCs").

We also pride ourselves on the Limited Partners ("LPs") we have attracted, many of whom are world-class non-profit organizations and leading universities. Our LPs are institutions and endowments that are large enough to seek to diversify by investing a portion of their assets in the high risk/high reward asset class of early-stage venture. Our current fund has 57 LPs including institutions such as the Mayo Clinic, the World Bank and Notre Dame University. The majority of our LPs have been investing with us over multiple funds.

We applaud the efforts of the SEC to define what it means to be a VC Fund, and appreciate the difficulty of creating a definition that is neither too broad nor too narrow. However, we have serious concerns about some of the details of the proposed definition, as we describe in more detail below. If the definition of VC Fund is not modified in some important respects, then CRV will not be able to characterize itself as a VC Fund. It is our view that if, following the promulgation of these rules, CRV is not able to fit itself within the definition of a VC Fund, then no one will be able to, as there could not be a firm that has remained more consistent with the mission of an early-stage venture capital fund over such a long period of time.

<u>How Do Our Own Limited Partners Define a "VC Fund"?</u>

No one can have a keener interest in defining what it means to be a "VC Fund" than our own LPs. Our LPs have to make complicated and difficult decisions about how much of their own endowments/pension funds/pools of capital to allocate to "venture capital," as opposed to other asset classes such as private equity, buyout, hedge funds and the like. And so, once an LP has made its allocations, it is of utmost importance to them that their outside money managers not subvert those investment allocations by shifting strategies once the money has been committed. To that end, as far as I am aware, every venture capital Limited Partnership Agreement contains a set of "investment limitations" that constrain what the venture capital firm may and may not invest in.

Our own LP-imposed legal restrictions (which have not changed materially over the decades), designed to ensure that we are behaving/investing like a venture capital firm, consist of the following:

> "Without the prior consent of a majority-in-interest of the Limited Partners:
>
> (a) The Partnership's total investment in any single portfolio company shall not exceed 15% of the aggregate subscriptions of all Partners;
> (b) The Partnership's total investment in the securities of one or more companies that, at the time of the Partnership's initial investment, have any securities traded on a Public Securities Market shall not exceed 10% of the aggregate subscriptions of all Partners; *provided, however,* that such 10% limitation shall not apply to securities acquired in a "going private" transaction or series of transactions.
> (c) The Partnership shall not lend funds to or guarantee any obligations of the General Partner or any affiliate of the General Partner; and
> (d) The Partnership shall not participate in investments in any company if such investment is actively opposed by the board of directors of the company."

We provide this information by way of comparative example, so that the SEC can see how it is that our own LPs define what it means to be a VC Fund.

<u>Comments on the SEC's Proposed Definition of a "VC Fund"</u>

1. Under the SEC's proposal, a VC Fund must own solely "equity securities" of its PCs.

The vast majority of our investments are in the form of Convertible Preferred Stock. Sometimes, in order to bridge a company to its first or next round of financing, we invest in the form of Convertible Promissory Notes, which convert into the next round of equity financing. So far, so good. However, very rarely - - but more often than never - - we invest in the form of a straight, non-convertible Demand Note. These situations are hard to predict: one recent case involved a clean-tech company where a co-investor was a state agency that was delinquent on its payment obligation. The company needed money in the interim to fund payroll and hence we made a short-term non-convertible loan to bridge the company until the money came in from the state.

We were not interested in increasing our ownership in the company at this point in time (hence no conversion feature), but simply wanted to help out a PC in pinch. While as noted above this is rare, it remains our view that this should not be prohibited. **Accordingly we propose a "de minimis" exemption, so that one could still be a VC Fund so long as at least 80% of the VC Fund's committed capital is in the form of "equity securities."**

2. Under the SEC's proposal, at least 80% of the securities owned by the VC Fund (on a per PC basis) must have been acquired from the PC directly.

While again the vast majority of our securities are "original issuances" from the PC, there are also instances where (1) we want to own more of a company, but the company does not want to take any further dilution, so, in order to get the ownership we need, we buy shares not just from the company but also from existing investors, or (2) the founders have a kid or two to send to college (or other such pressing financial need), and we buy some shares from them directly, in order to give them some liquidity. In our experience, these types of secondary purchases, while still the exception rather than the rule, are becoming more and not less common. We think this may be in part a result of the poor economy, where individuals (angel investors and founders) may face liquidity constraints and be willing, or need to, sell shares. While we feel confident that this will only take place in a minority of our deals, it is certainly possible that in any given deal we might acquire, say, 25% of our shares in the portfolio company in this manner. That is to say, we think the 20% rule is too restrictive in that the denominator consists of the securities of just one PC. **Accordingly, we propose that the 20% test be taken against committed capital (rather than per portfolio company), so that 80% of the securities *in the entire fund* are "original issuances."**

3. Under the SEC's proposal, a VC Fund's investments all must be in "qualifying portfolio companies" ("QPCs"), defined as PCs that (i) are not publicly traded, (ii) do not incur leverage in connection with our investment, (iii) do not redeem or repurchase securities in connection with our investment and (iv) are not themselves funds.

CRV's investments would fall afoul of most of these requirements, which is again why we believe a *de minimis* allowance is required, in order to prevent foot-faults. Even a VC Fund in the truest sense, like CRV, will *occasionally* make investments that violate one or more of the limitations set forth above.

(i) Public company securities: CRV has in rare instances purchased additional stock in a PC after the PC went public (but before we have distributed any of the PC stock to our own LPs, because it is illiquid due to either lock-ups, Rule 144 restrictions or some combination thereof). We have done this because, as an investor who has been close to the company since its inception, we make the judgment that even buying it at public market prices (vs. early stage private financing rounds) will provide good value to our LPs. Note that our own LPs have always given us a 10% allowance per fund, and that seems like a reasonable *de minimis* allowance (especially for life science VC firms that do from time to time invest in PIPEs transactions). **Accordingly, we propose that up to 20% of the committed capital in a VC Fund may be invested in public securities.**

(ii) No leverage in connection with investments: Even early stage VCs like CRV, particularly in this economy where the IPO market remains anemic, will from time to time find themselves having to support a PC through a later stage round in which a PE/later-stage type fund steps in to lead the investment round and invests in the form of both debt and equity. In other words, it is not just possible but highly probably that we are in investments in the Series A, Series B and Series C rounds, and then the company finds it still needs more capital to get to a sale or IPO, and brings to the table a later-stage investor, who insists on investing in the form of both debt and equity. We would participate in this round to maintain our percentage ownership, even though we personally would not invest in the form of debt. **Hence we propose that the definitions be modified to permit leverage in connection with equity investment, *so long as the firm that is seeking to be classified as a VC Fund is not the one mandating or providing the debt instrument in connection with its equity investment.* Alternatively, we propose that up to 20% of the committed capital in a VC Fund may be invested in QPCs that violate the borrowing strictures to which QPCs must adhere.**

(iii) No redemption or repurchase in connection with our investment: As noted above, there are certainly instances (with increasing frequency) where the company is using proceeds from the financing to immediately repurchase some portion of the founder shares, to give them liquidity. **Here again we would**

propose a *de minimis* exemption, where our investments can still be considered to consist of investments in QPCs if this has happened in fewer than 20% of all of our investments (based on committed capital).

4. Under the SEC's proposal, investments must only be in operating companies, and not in funds:

   Although again the vast majority of our investments over 40 years have been in operating companies, there have been limited but significant exceptions to this rule. The occasions on which we have invested in a pass-through vehicle include (and in the future are likely to include) the following:

   - a technology incubator that creates and spins out start-ups;
   - a company that is in the "invention business," and whose assets consist almost entirely of the resulting patent portfolio – structured as a pass-through because the inventor-stakeholders are individuals (natural persons) for whom such structure is most tax efficient;
   - an LLC whose other members (in addition to our fund) are well-connected technology entrepreneurs who help us identify promising companies and then invest in them with us, side by side, through this LLC (note that such "sub funds" are an increasingly popular vehicle for VCs to make very early stage seed investments);
   - when one of our PCs was recently sold, the buyer did not wish to purchase one asset, a contract that still has a future revenue stream payable; accordingly, that one asset was "cabined" in an LLC that exists only to collect the accounts receivable.

   Accordingly, we propose that it should be permissible to invest in an entity that is not an operating company so long as any of the following is true: (1) the entity does not charge any carried interest to the VC Fund or its LPs (i.e., the entity in question is used simply for structural reasons); (2) the entity itself could qualify as a VC Fund; or (3) no more than 20% of the VC Fund's committed capital is invested in such flow-through entities.

5. Under the SEC's proposal, the VC Fund must offer managerial assistance with respect to each PC.

   We do not see this as problematic, although again a *de minimis* exemption is well advised. Although we ask for so-called "management rights" in each and every company we invest in for purposes of complying with the "venture capital operating company" ("VCOC") rules under ERISA, we can't say that we've never had a single company that has put its foot down (for whatever reason) and refused – usually on the grounds that "then all other investors will have to get these rights as well, and it is a nuisance." We note that the VCOC rules themselves do not require anywhere near 100% compliance. **Accordingly, we propose that a fund may qualify as a VC Fund if it has VCOC-compliant "management rights" in at least 80% of its portfolio, measured as a percent of committed capital.**

6. Under the SEC's proposal, the VC Fund must not borrow in excess of 15% of its aggregate committed capital, and the term of such debt can't be longer than 120 days.

   For the first time in its history CRV recently found itself in the position where it needed to arrange for a line of bank credit for one of its funds. One of our funds, raised during a time of "normal liquid markets," had invested all of its committed capital, but still has potentially valuable companies in its portfolio which are likely to require additional capital before achieving liquidity. If we don't participate in the future rounds of funding, we risk having our entire Preferred Stock interest converted to less valuable common stock (pursuant to so-called "pay to play" provisions) or, at minimum, having our equity stake diluted. Hence, in order to preserve and protect this future value for our LPs, and with their written consent (required under our fund documents), we entered into a credit arrangement with a bank. If and when we ever draw on that line, the term of the debt is almost certain to be longer than 120 days, as it will be repaid first out of future liquidity events. This is a situation that is far from unique to CRV, and arises when liquidity is limited or unavailable for prolonged periods. We are aware that *many* VC firms have faced this issue, and attempted to solve it in different ways. With the advice and consent of our own LPs, we chose to solve it by proactively arranging for a line of credit. **Accordingly, we propose that, *with the consent of its LPs*, a VC Fund should be permitted to borrow up to 20% of its committed capital, with no fixed limit on the term of such debt.**

7. Under the SEC's proposal, a VC Fund must not give its LPs redemption rights.

We do not see this as at all problematic or requiring even a *de minimis* exemption.

Conclusion

We have elected 20% of committed capital as the permissible foot-fault margin throughout because it would be difficult for a VC Fund to manage, and the SEC to monitor, a hodgepodge of inconsistent carve-outs and exceptions. It may be a more manageable solution to simply allow a VC Fund to invest 20% percent of its committed capital in otherwise "non-conforming" investments, of whatever type – up to a maximum of $100M, given that a $500M fund would be on the large side for a VC Fund. If the exception is provided on this "one large bucket" basis, we believe anything less than 20% would be inadequate, given the small sizes of VC Funds and the multiple and often unexpected ways in which we may violate the black letter of the proposed rules, as described above.

On a related point, because the definition has so many elements, many of which could be read as foreclosing ordinary business practices of venture capital funds, we urge the SEC, when it promulgates the final criteria, to provide as many examples and illustrations as possible in connection with each, particularly to the extent where it can allay any concerns about what the definition is *not* meant to cover/foreclose.

Again, we appreciate the difficult task the SEC faces in setting criteria that are sufficiently inclusive to embrace the way that venture funds operate, without being so broad as to allow later stage private equity firms or hedge funds to squeeze in under the gate. However, as discussed above, we believe that the SEC definition ignores, and would prohibit, some of the business practices that are actually quite routine in and entirely consistent with early stage venture capital. We hope this letter has shed some light on those issues, and would be more than happy to answer any further questions and engage in further dialogue on this topic.

Thank you for your consideration.

Sincerely,

The General Partners of Charles River Ventures