Venrock

Building Companies that Shape the Future

January 23, 2011

Via Electronic 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 a "venture capital fund" (VCF). The Proposed Rules set forth this new definition.

Venrock[1] is pleased to have the opportunity to comment on the Proposed Rules, with a specific focus on the Commission's proposed definition of a VCF for purposes of the new VCF Exemption. Once finalized, the Commission's definition of a VCF will have a significant impact on the venture capital industry, not only defining which venture capital funds will continue to be exempted from the significant expense and time commitment required to comply with the reporting regime under the Advisers Act, but also for the first time setting forth a common definition of a venture capital fund that is likely to be incorporated into future federal and state legislation entirely unrelated to the securities laws.

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[1] Venrock is one of the oldest venture capital funds in existence. Originally established as the venture capital arm of the Rockefeller family, Venrock continues an eight-decade tradition of partnering with entrepreneurs to establish successful, enduring companies. Having invested over $2.6 billion in approximately 460 companies resulting in 128 IPOs and 137 successful M&As over the past 40 years, Venrock's investment returns place it among the top tier venture capital firms that have achieved consistently superior performance. With a primary focus on technology, healthcare, and energy, portfolio companies have included Apple Computer, Athenahealth, Centocor, Check Point Software, DoubleClick, Gilead Sciences, Idec Pharmaceuticals, Illumina, Intel, Millennium Pharmaceuticals, Sirna Therapeutics, StrataCom, and Vontu. For more information, please visit Venrock's website at www.venrock.com.

The venture capital industry has long been one of the drivers of the US economy. Over 12 million U.S. jobs and nearly 20% of U.S. GDP can be traced to companies that were originally venture backed. Venture capitalists are typically long-term investors who succeed only when their portfolio companies dramatically grow in size and scale, which aligns venture capitalists with Congress in their mutual interest in promoting growth, increased employment, and stability in the U.S. economy. Venture capitalists rarely use leverage to purchase investments (many are prohibited from using leverage in this manner), which when considered with their typical long-term investment horizons, demonstrates that venture capitalists do not engage in the types of short-term highly-leveraged real estate and derivates-based investing that contributed so dramatically to the current difficult economic climate. In addition, the investors that provide the bulk of the capital invested in venture capital funds are pension plans, university endowments, state and local governments, charitable foundations, and similar investors. As a result, much of the profit generated by venture capital funds actually accrues to government agencies, universities and local schools, hospitals, retirees of municipal jobs (such as teachers, fire fighters, and police officers), and charitable organizations.

It was in recognition of these facts that Congress created the VCF Exemption to the Dodd-Frank Act. Congress understood that venture capital investors, who implement a long-term unleveraged approach to building companies that promote jobs and innovation, are important to the health of the U.S. economy and do not present the types of systemic risks Congress sought to prevent in the Dodd-Frank Act. As a result, the SEC should strive to create a definition of a VCF that is broad enough to capture as many venture capital funds as possible as long as they conform to these parameters.

Venrock believes that the definition of a VCF as proposed by the SEC in the Proposed Rules will exclude a significant number of existing venture capital funds. However, Venrock believes that with two modifications to the proposed definition, the definition would then capture the vast majority of existing venture capital funds and much more closely implement the intent of Congress in creating the VCF exemption. These two modifications are described in detail below:

1. Exclusion for up to 15% non-qualifying investments or activity.

In a letter to the Commission dated January 13, 2011, the National Venture Capital Association (NVCA) proposed several modifications to the definition of a VCF. While Venrock supports each of these suggestions, Venrock believes that the NVCA's suggestion of an exemption for a limited amount of permissible non-qualifying investments or activity not to exceed 15% of a VCF's capital commitments is a vital modification to the proposed definition without which the definition as proposed will fail to capture a significant number -- perhaps even a majority -- of existing venture capital funds.

The lack of such an exclusion for non-qualifying investments or activities means that any non-compliant investment or activity -- no matter whether inadvertent, unintended, or insignificant -- would result in a venture capital fund falling outside the VCF definition and thereby needing to comply with the expensive and time consuming process of registration.

We believe that the Commission was thoughtful and thorough in formulating a proposed VCF definition that describes the behavior of a venture capital fund in general. However, the definition fails to identify the myriad of activities that the vast majority of venture capital funds occasionally undertake that are outside the proposed definition; while any one of these other activities may not be typical for all funds, engaging in some of them on occasion is highly typical. Venrock agrees with the statement by the NVCA that existing venture capital funds will need to undergo "significant behavior change in order to ensure compliance with the VCF Exemption's many requirements" as proposed. Rather than attempting to identify each of these occasional activities or ignoring their existence and thereby requiring the vast majority of venture capital funds to significantly change their current practices (which, as currently structured, Congress deemed of low systemic risk in drafting the Dodd-Frank Act), Venrock believes that an exemption for a limited amount of permissible non-qualifying investments or activity (not to exceed 15% of a VCF's capital commitments) should be added to the VCF definition.

2. Investments in Public Companies

Venrock believes that the VCF definition should be modified to allow VCFs to invest in small capitalization public companies so long as both (1) at least 85%[2] of these investments are held for not less than one year and (2) the investments meet the other general requirements identified by the Commission (i.e., that they are long-term, unleveraged investments by privately-traded funds without routine redemptions that hold themselves out as utilizing a "venture capital" investment strategy).

Venrock believes that the current definition of the VCF Exemption would eliminate one of the few vital funding sources of long-term capital for small-cap and early-stage public technology and healthcare companies. These companies employ hundreds of thousands of U.S. workers and drive significant innovation in our economy. Many of these companies conduct significant research and development activities or large clinical trials subsequent to their initial public offerings (IPOs) and thus require substantial additional infusions of investment capital (often tens of millions of dollars). These companies, typically with no or very limited revenues, normally cannot raise sufficient funding from banks or similar institutional lenders. In addition, with their generally low valuations and highly limited trading volumes, these companies are typically abandoned by normal public company-focused institutions, receiving little or no research or analyst coverage and falling well below the minimum investment guidelines of most institutional public investors. Venture capital funds are viewed as a strongly preferred source of capital for these companies, because venture capital funds are long-term fundamental investors that do not engage in speculative day-trading or derivative-type trading activities. Further, compared to publicly-traded funds, venture capital funds are also regarded as a stable source of capital because they are not under pressure to liquidate holdings periodically to fund quarterly or other routine

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[2] Venrock suggests 85% to parallel the suggested exemption for a limited amount of permissible non-qualifying investments or activity not to exceed 15% of a VCF's capital commitments. Venrock notes that, if the 15% exemption is implemented, then a general requirement for investments in public companies to be held for at least one year to qualify as a VCF would be practical, given that up to 15% of these investments could be held for less than a year under the exemption.

redemptions by their investors and typically have long partnership terms (often ten years or more).

To a long-term investor, like a venture capital fund, small-cap and early-stage public companies, many of which have very limited trading volumes and thereby very limited liquidity, are highly similar to an investment in a private company.[3] In addition, these companies are often at comparable early stages of product development when compared to mature private companies. Because these companies are illiquid, primarily research focused, and often years from profitability, few traditional public investors are willing to provide funding.

While the proposed prohibition on investments in public companies was intended to further prevent hedge, mutual, private equity, or similar funds from trying to qualify under the VCF Exemption, the requirements not to be publicly traded, not to use leverage, and to prohibit short-term holding periods would effectively negate the ability to implement any of these non-venture capital strategies.

Venrock believes that to deprive small-cap and early-stage public technology and healthcare companies of an essential source of significant funding, which presents no systemic risks of the type Congress intended to target in the Dodd-Frank Act, would not implement the intent of Congress in creating the VCF Exemption and could threaten significant numbers of jobs and weaken innovation in our country. Venrock strongly urges the Commission to permit VCFs to continue to make substantial investments in small-cap and early-stage public technology and healthcare companies and believes that the parameters described above would create a reasonable framework within which venture capital funds could continue to provide this funding.

Conclusion

Venrock believes that the VCF definition in the Proposed Rules reflects a thoughtful and thorough attempt to craft a description of the most common operations of the venture capital industry. However, the two significant changes noted above are required to permit the definition to accurately reflect the actual operations of a typical venture capital fund. 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.

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[3] Venrock believes that it is quite uncommon for venture capital funds to invest in mid-cap and large-cap public companies. While the requirement to hold any such investments for at least one year would eliminate any potential systemic risk from these investments (because a short-term or derivatives-based strategy could not be employed), if the Commission was concerned that allowing investments in mid-cap and large-cap public companies would unduly create the risk of a loophole that might be exploited by other funds that are not truly venture capital funds, Venrock believes that it would not be unreasonable to include a maximum market capitalization (e.g. $1 billion public float) above which investments in public companies would not qualify for treatment as exempt VCF investments.

Under the Proposed Rules, however, there is risk that many venture capital funds may be forced to register as investment advisers or to cease current investment practices that, as noted above, support our economy and job creation without additional systemic risk. Moreover, without some measured degree of flexibility in the VCF definition, the exemption for investment advisers to venture capital funds may be rendered nearly meaningless, because many such advisers will fail to qualify for the proposed definition without significant modifications to their current business practices. This result would not implement the intent of Congress or enhance the stability of the financial markets. Rather, it would stifle innovation, economic growth and job creation at a time when Congress recognized the longstanding role of the venture capital industry in promoting 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 any Venrock Partner at (650) 561-9580.

Sincerely yours,

David L. Stepp
General Counsel