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VIA E-Mail

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
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cc: NVCA

Re: 17 CFR Part 275 [Release No. IA-3111; File No. S7-37-10] RIN 3235-AK81 Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers

Preface

We are pleased to respond to the request for comments posted by the Securities and Exchange Commission as it develops regulations growing out of the recent "Dodd-Frank" legislation. They are offered in the context of this preface.

In general, Congress was right to create a blanket exclusion for "venture capital funds" in section 407 of the legislation. Venture capital funds create no systemic problems (or even smaller ones) that require more or tighter regulation. Indeed, venture capital funds are engaged in the kind of company-forming, job-creating activities that are universally desired by Americans of all backgrounds and political beliefs.

In crafting the definitions and language of the exclusion, however, the SEC should recognize that there are a wide variety of practices in the venture capital industry. At several points, the proposed regulation or discussion about it uses the terms "common" or "typical" to describe venture capital industry practices, and to use those common or typical practices as the basis of the proposed regulation.

Venture capital has been an innovative area of finance. There may be common or typical practices, but there also are variations on those practices. Practices also evolve over time in response to market conditions and innovations. Practices in some geographies—the Midwest, for instance—

may be different than those in other markets like Silicon Valley. Practices that are common in life sciences investing may be different than practices in technology or cleantech investing.

Therefore, the definitions of the exclusion for venture capital funds must be flexible and allow for adaptive creativity.

Please consider the following specific comments in light of the preceding general remarks.

Definition of a Venture Capital Fund

The proposed definition includes the following:

"...a venture capital fund as a private fund that: (i) invests in equity securities of private companies in order to provide operating and business expansion capital (i.e., "qualifying portfolio companies," which are discussed below) and at least 80 percent of each company's securities owned by the fund were acquired directly from the qualifying portfolio company....(iii) does not borrow or otherwise incur leverage (other than limited short-term borrowing)..."

Equity Securities v. Debt Securities

Response 1: The definition should be expanded to include "debt securities." There are many instances in which venture capital funds invest by way of debt securities. These circumstances could include:

1. An investment is made in a pure start-up for the purpose of determining whether a technology or idea can be developed into a product. There may be no company formed or any intention to go to the expense of incorporation until the technology has demonstrated proof of concept. The team may consist of a few technical people who are being paid as consultants. The venture capital company may play the role of co-founder and provide management supervision. There may be no central physical location for the business. The technology may be developed at a university or company under contract, or by a group of people operating from home. If the technology proves out, the debt securities may convert to equity. If the technology doesn't prove out, the company's assets and intellectual property may be sold in satisfaction—or more likely partial satisfaction—of the debt.
2. An existing portfolio company is raising a next round of funding, with the intention to find a new outside investor to establish the valuation of the company. Current investors agree to provide "bridge funding" in the form of a note, with the intent that the notes will convert into the next round equity securities. These types of debt bridge financings were very common during the last economic cycle, as venture capital funds were forced to support existing portfolio companies for longer than anticipated due to the absence of new investors.
    a. Debt bridge financings may occur when an investment is performing, and current investors wish to support it, but the founders believe a new outside investor would establish a higher valuation for the company. A note enables existing investors to continue financing a promising company without arguing with founders about valuation. A new investor establishes the company's valuation to the satisfaction of all parties.

b. Debt bridge financings also may occur when an investment is promising but behind plan, and investors want to protect themselves from a "down round" led by new investors. If additional money was invested in equity securities at the previous valuation and new investors put a lower valuation on the company, existing investors would experience an immediate loss. Alternatively, a note would convert into the new equity security, side-by-side with new investors at the same valuation and with the same terms and the bridge money would not immediately experience a loss.
c. Sometimes these bridge facilities remain in place for a significant period of time, as long as two years or more, while companies prove out their technology, find customers, or seek additional financing from new investors. Again, in the recent economy downturn, this was common.

Response 2: There should be no requirement that debt securities purchased by venture capital funds convert into equity.

There are circumstances in which the Company or the venture capital fund will prefer that a note be repaid with interest, rather than converting into equity. This might happen when a venture capital fund provides bridge funding to a next round equity financing by new investors and the valuation of that financing is very high. The venture capital fund might decide that it can obtain a better return on investment by having its debt securities redeemed and investing that money in another company.

Response 3: There should be no limit to the percentage of securities a venture capital company buys from existing shareholders.

The requirement that 80% of the securities owned by the fund be purchased from the company is arbitrary and inflexible. It is not uncommon for founding entrepreneurs to leave startup companies—voluntarily or otherwise. They may wish to sell their shares, or the Company may wish to buy them back to avoid having a disgruntled shareholder. It may be in everybody's best interest to have those shares owned by current investors rather than sold to an outside party or held by an unhappy former founder. In this case the venture capital fund may want the flexibility to be able step in and buy those shares. If that action would breach the proposed 80% limit, however, it would reduce the options available to manage this circumstance. Additionally, a venture capital fund could inadvertently breach the 80% limit and lose its exemption, with all the consequences that would result.

Definition of Qualifying Portfolio Companies

It would appear that a central concern expressed in this section of the proposed regulation is "leverage" due to Congress being concerned that high leverage is a risk to the financial system. Though venture capital investment is generally in the form of equity, that equity often enables companies to simultaneously obtain additional, less expensive, debt capital to, as we say "extend the company's runway." Seldom does this result in high leverage, but the proposed definition would exclude debt of any kind.

Portfolio Company Leverage

Proposed Defined term 1: "... (ii) does not incur leverage in connection with the investment by the private fund..."

Response 1: Leverage should be permitted. There should be no limit on leverage because companies have widely varying business models and circumstances.

There is an entire class of capital, provided by a number of different firms, which is called "venture debt." It is common for venture-backed companies to obtain venture debt in association with an equity investment. This definition would seem to exclude that practice.

Early stage companies also typically seek to obtain loans from state governments, asset-backed loans, and commercial lending lines. Often it is possible for venture-backed companies to obtain these types of debt because the lender takes comfort from (and may be explicitly guaranteed by) the venture capital equity investors.

In practical terms, companies that have not yet achieved profitability will have limited options for leverage, as determined by lenders. There is no way a single regulation can determine what the appropriate level of leverage should be for every portfolio company. Lenders are better suited to make that determination, in concert with the judgment of the board of the portfolio company about what is appropriate.

Proposed Defined term 2: "...(iii) uses the capital provided by the fund for operating or business expansion purposes rather than to buy out other investors..."

Response 1: Venture capital firms should be permitted to buy shares from founders or earlier investors.

There may be circumstances in which it is advantageous to all parties for the newly invested capital to buy out other shareholders instead of buying newly issued shares. There may be a co-founder of the company who has had a falling out with partners and wants to be bought out. There may be angel investors who have deal fatigue, are disgruntled and want to sell. There may be founders who are leveraged on their credit cards and mortgages and wish to pay down personal debt by selling some of their shares to new investors—and the investors may want to focus company management on executing the business plan by removing this stress in their personal lives.

In all of those circumstances, the good of the enterprise may be served by having a venture capital fund acquire shares from a founder or previous investor.

Publicly Traded Securities

SEC Question: "We request comment on whether our definition should exclude any venture capital fund that holds any publicly traded securities or a specified percentage of publicly traded portfolio

company securities. What percentage would be appropriate? What percentage would give venture capital funds sufficient flexibility to dispose of their publicly traded securities? Would 30 or 40 percent of the value of a venture capital fund's assets be appropriate? Should the rule specify that publicly traded securities may only be held for a limited period of time, such as one year, or that a venture capital fund's entire portfolio may not consist only of publicly traded securities except for a limited period of time, such as one-year or other period?

Response 1: There should be no limit to the percentage of assets held in a venture capital fund represented by public securities, provided that the company was private when the venture capital fund initially invested in it, or became private with the investment by the venture capital fund.

A portfolio company that achieves an IPO is likely to represent a disproportionate percentage of the asset value of the venture capital fund portfolio at that time—particularly if the IPO occurs early in the life of the venture capital fund and its other investments are still developing. It is entirely plausible that holdings in companies such as Google or Facebook could, because of their dramatic success, represent well over 50% of the entire portfolio value of the fund that invested in it. If all the other investments in the fund failed, a single company could represent 100% of the asset value of the fund.

There is no problem to solve here that requires an arbitrary setting of the percent of venture capital funds that can be in public securities.

Response 2: There should be no limit to the timing of the disposal of public shares held by a venture capital fund, provided that the company was private when the venture capital fund initially invested in it, or became private with the investment by the venture capital fund.

There are several reasons why venture capital funds need flexibility and to be able to exercise discretion in the timing of the disposal of shares after an IPO.

For one, there may be a "lock-up" period imposed by the investment bank leading the IPO that prevents a venture capital fund from disposing of its shares for a period of time; sometimes up to a year.

There also may be volatility in the share price of a company. The venture capital fund, with the agreement and advice of its investors (Limited Partners), may develop a plan for orderly disposition of public shares over time to optimize returns. This is not dissimilar to the considerations being applied by the U.S. Department of Treasury to the federal government's holdings in General Motors and AIG.

Finally, there may be tax considerations that affect the timing of the disposition of shares.

There is no problem to solve here that requires an arbitrary setting of the timing of a venture capital fund selling public securities.

Securities Purchased In Qualifying Portfolio Companies

SEC Proposal: We propose to use the definition of equity security in section 3(a)(11) of the Securities Exchange Act of 1934 ("Exchange Act") and rule 3a11-1 thereunder. This definition is broad, and

includes common stock as well as preferred stock, warrants and other securities convertible into common stock in addition to limited partnership interests....

....Should we consider a more limited definition of equity security?

Response 1: No.

Venture capital funds typically buy preferred stock. However, they may buy common stock as co-founders of companies or buy common stock from founders who depart the company. Venture capital investors may receive warrants convertible into either preferred or common stock.

SEC Question:... Do venture capital funds typically invest in other types of equity securities that are not covered by the proposed definition?

Response 1: The use of the word "typically" in the question will likely result in the answer "No" from most respondents. However, the rule should be defined broadly enough to enable professional venture capital investors to structure securities that best suit the circumstances. For instance, "redeemable preferred" securities are sometimes used—not "typically" but occasionally. There may be other forms of securities that are also used, or have not yet been devised but may suit particular circumstances.

Cash Holdings of Venture Funds

SEC Question: 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?

Response 1: There should be no restrictions on how or in what security venture capital funds hold cash.

Different venture capital funds take different approaches to cash management, but most venture capital firms don't sit on large piles of cash. They receive "commitments" from Limited Partners, but cash is only transferred from the Limited Partners to the venture fund ("draws") either as needed (for overhead or investments) or on a specified schedule (for instance, quarterly). Some venture capital funds may use lines-of-credit or other instruments to manage cash flow between draws. In general, venture capital funds do not want to draw too much capital because, once the cash is drawn, the time period begins for calculating investment returns. Holding cash in treasury securities or other such instruments would depress investment returns for venture capital funds.

Nevertheless, there is no problem to solve here that requires a regulation.

Management Involvement

Proposed Defined Term: "To qualify as a venture capital fund under our proposed definition the fund or its investment adviser would: (i) have an arrangement under which it offers to provide significant guidance and counsel concerning the management, operations or business objectives and policies of

the portfolio company (and, if accepted provides the guidance and counsel) or (ii) control the portfolio company.

Response: There is no need for this definition.

The level of involvement a venture capital fund takes in a portfolio company may vary with the circumstances, including the experience of the company's management team. The venture capital fund generally does not try to "manage" or "control" a portfolio company but, instead, to build a strong board with independent directors and good governance practices, and to recruit and retain quality management. An experienced management team coupled with a strong, functioning board is the model for successful VC company formation and success; developing both takes time and significant VC involvement (including the exercise of sound judgment).

The relationship is seldom a formal "arrangement" but is more informal, based on personal relationships and circumstances, and evolves over time.

The definition also suffers from the vagueness of the usage "significant."

The definition also suffers from an implied assumption that there is only one venture capital fund involved in a portfolio company. In practice, there may be multiple venture capital funds that invest in a single company, with different amounts of capital and different levels of management involvement over time. How could multiple venture capital companies each meet the proposed definition?

Thank you for the opportunity to comment on these proposed regulations.

Sincerely,

Jonathan Murray

Managing Director

Early Stage Partners