New York
Menlo Park
Washington DC
London
Paris
Madrid
Tokyo
Beijing
Hong Kong

Davis Polk

Davis Polk & Wardwell LLP
1600 El Camino Real
Menlo Park, CA 94025
650 752 2000 tel
650 752 3602 fax

January 24, 2011

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)

VIA EMAIL: rule-comments@sec.gov

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Dear Ms. Murphy:

Davis Polk & Wardwell LLP is providing this comment letter with respect to the proposed rules (the "Proposed Rules") set forth in Release No. 1A-3111 (the "Release"), to implement the new exemption from the registration requirements of the Investment Advisers Act of 1940 (the "Advisers Act") for advisers solely to venture capital funds (the "VCF Exemption"). In particular, our comments focus on the proposed definition of "venture capital fund" (the "VCF Definition") for purposes of the new VCF Exemption.

Our firm represents a number of venture capital funds, advisors to and investors in venture funds, and companies financed by venture funds. We recognize the importance of the venture industry in creating world class companies and millions of jobs, and in the need to get the VCF Definition right, to ensure that the ecosystem created by the venture industry will continue to thrive. We also appreciate the time and effort of the Commission in crafting a VCF Definition which reflects the activities of, and investments made by, venture funds, and believe that, for the most part, the proposed VCF Definition achieves these objectives. We believe that the changes to the Proposed Rules which we are suggesting will provide a closer alignment between the VCF Definition and the actual operation of venture capital funds, and build additional flexibility to ensure that venture capital funds will not inadvertently fail to meet the VCF Exemption. We believe that our suggested changes will not increase the possibility that venture capital funds will impose systemic risk on the financial markets.

In preparing this letter, we reviewed the comment letter dated January 13, 2011, submitted by the National Venture Capital Association with respect to the Proposed Rules (the "NVCA Letter"). With one exception noted in Section IV below, we agree with the positions expressed in the NVCA Letter. This letter does not attempt to go through all the issues discussed in the NVCA Letter or in the Release (and in particular, we do not give answers to questions raised in the Release relating to the VCF Exemption where we agree with the approach taken in the Proposed Rules). Rather, we wanted to highlight in this letter the changes we believe are most important to bring the Proposed Rules into better alignment with the actual operation of venture funds.

I. Qualifying Portfolio Companies.

The most important deficiency with the proposed VCF Definition is the requirement that a VCF invest exclusively in "qualifying portfolio companies". Under the Proposed Rules, a venture fund would lose its exemption if one of its investments ceased to be a "qualifying portfolio company." We believe that the exclusivity requirement puts a venture capital fund at too much risk of losing the exemption. We note that for many investments, the venture fund does not control the portfolio company. Since a number of the criteria which determine whether a portfolio company will satisfy the "qualifying portfolio company" definition depends on the actions of that portfolio company, a venture fund could inadvertently fail to satisfy the VCF Definition because of actions taken by the portfolio company's board or management. We suggest that this problem can be remedied by eliminating the exclusivity requirement and providing for a permissible level of non-qualifying activity, not to exceed 15% of a venture fund's capital commitments.

(a) "Private Companies" Requirement. The Proposed Rules do not permit investments to be made in companies which are publicly traded at the time of investment. However, in practice, venture funds may need to support their portfolio companies after IPOs, and in particular, those companies with capital intensive requirements, such as life science companies. We suggest that the definition of "qualifying public companies" permit investments in a public company, provided that the venture fund's initial investment was made when the portfolio company was private, and the venture fund continues to hold at the time of the public company investment a majority of its pre-public investment in such portfolio company. To prevent possible abuses, the Proposed Rules could be modified to provide that no more than 20% of a venture fund's committed capital could be invested in securities purchased from public companies. The Proposed Rules could also provide that any such public company purchases must be made directly from the issuer.

The "qualifying public company" definition should also be modified to permit a venture fund to hold public company securities acquired as merger consideration upon the sale of a portfolio company to a public acquiror, or to an acquiror which would not otherwise meet the standards of "a qualifying portfolio company". These portfolio company sale transactions should not prevent a venture fund from satisfying the VCF Definition, especially since the venture fund may not have the power to prevent such portfolio company sale.

(b) Equity Securities, Cash and Cash Equivalents and Short-Term U.S. Treasuries.

(i) Bridge Financing. Bridge financings constitute an important mechanism to keep cash starved private portfolio companies operating until permanent sources of equity capital are found. These portfolio companies often have no access to conventional bank or factoring facilities. Although many bridge financings may ultimately be convertible into portfolio company stock and thereby meet the definition of "equity security," in some cases, the venture fund which provided the funds will be reimbursed. We suggest that the Proposed Rules permit non-convertible bridge loans with maturities of 180 days or less, and with up to one 180 day rollover period. We believe that the aggregate amount of such non-convertible bridge loans outstanding at any time could be limited to 5% of a venture fund's committed capital.

(ii) Cash, Cash Equivalents and U.S. Treasuries. The types of permissible short term investments in the Proposed Rule should be expanded to include the typical safe short term investments permitted in customary venture fund limited partnerships agreements.

(c) Venture Capital Fund Secondary Purchase Limitations. We agree with the Proposed Rules' attempts to differentiate venture capital funds from other private equity funds based on two key characteristics: (i) who the fund buys from, and (2) the use of leverage by the portfolio company to help finance the fund's investment or to provide liquidity for such investment. We agree that a venture fund typically purchases primary shares directly from the portfolio company to fund the issuer's operations, and that the venture fund typically obtains liquidity either through sales in the public market following the portfolio company's IPO or upon the sale of the portfolio company rather than through leverage of the portfolio company. In contrast, many private equity funds acquire control of portfolio companies through purchases from investors. Often, a purchase is carried out through leverage of the portfolio company, and the private equity fund often obtains liquidity through a repurchase by a leveraged portfolio company.

However, the Proposed Rules need to be modified to account for two typical fact patterns encountered by venture funds. The first is that venture funds do make some secondary purchases of securities from founders, employees, ex-employees and vendors as well as other outside investors, who may have a need for liquidity when public markets are not available. This has been especially true in recent periods for private social media companies. Second, the portfolio company may act as an intermediary: in connection with a venture fund financing, the portfolio company may itself buy back the common shares typically held by these types of sellers, and issue preferred stock, which carry "investor-friendly" rights, to the venture fund.

To solve these particular problems while maintaining the basic distinction between venture capital funds and other private equity funds, we suggest that the Proposed Rules be modified as follows:

(1) Lower the secondary purchase limits for venture capital funds in any single portfolio company from 80% to 50%, and impose an aggregate secondary purchase limit per venture capital fund to 20% of such fund's committed capital, and

(2) Modify the "in connection with" language to permit a qualified portfolio company to repurchase shares from founders, employees, ex-employees and vendors, and to sell equity to venture capital funds or other investors to pay for such repurchases.

These modifications should not change the Proposed Rule's leverage limitations with respect to "qualified portfolio companies" or the VCF Definition.

(d) Operating Companies. While we agree that the Proposed Rules should apply to funds of funds, we believe that a venture capital fund should be permitted to use intermediate holding vehicles for structure its investors' holdings in its funds, and, in turn its portfolio companies, for legal, tax or regulatory reasons. As the NVCA Letter has pointed out, tax-exempt institutional investors and non-U.S. investors typically seek to avoid investments in tax-transparent operating companies in order to minimize taxes attributable to "unrelated business taxable income" or "effectively connected" income. At the same time, U.S taxable investors may prefer such form of investment due to U.S. tax efficiencies. Alternatively, investments may be made through holding companies in different jurisdiction for more tax efficient returns. To solve these structural issues, venture capital funds may set up separate structures, known as "alternative investment vehicles," for affected investors to invest in a qualified portfolio company in parallel with the venture capital fund. Such alternative investment vehicles should be permitted under the Proposed Rules.

II. No Redemption Rights. We recommend that the Proposed Rules clarify that the permission to make pro rata distributions to investors includes the ability of the fund manager to receive carried interest distributions.

III. Grandfathering Provision. The ability to rely on the Proposed Rule's grandfathering provision should not be based on the vocabulary used in the offering documents for grandfathered funds. Many older venture capital funds' offering documents may have referred to themselves as "private equity funds", used the description "multi-strategy" to refer to their sector, stage and/or geographical diversification strategy or referred to their "growth capital" strategy to mean late stage venture capital investing. If these funds were holding themselves out as having essentially the same purposes and characteristics as venture capital funds, their use of the term such as "private equity," "multi-strategy" or "growth capital" should not disqualify them from relying on the grandfathering provision.

IV. Disagreement with NVCA Letter. Our only significant disagreement with the NVCA Letter is the NVCA approval of a minimum 10 year term for venture capital funds to satisfy the VCF Defintion (see "Other Factors", on page 16 of the NVCA Letter). A number of our clients have established "annex funds" for making follow-on investments in portfolio companies of an existing fund, when the existing fund has no more capital to invest. Many annex funds have terms less than 10 years, but would otherwise be able to satisfy the VCF Definition. Similarly, some late stage venture funds also provide for shorter than 10 year terms. We believe the Proposed Rules should be flexible enough to permit shorter term funds to satisfy the VCF Definition.

We would be pleased to discuss our comments or any questions the Commission may have with respect to this letter. Any questions about this letter may be directed to Francis S. Currie at 650-752-2002 or Yukako Kawata at 212-450-4806.

Very truly yours,

Davis Polk + Wardwell LLP

DAVIS POLK & WARDWELL, LLP