VEDANTA CAPITAL

January 24, 2011

Via Electronic Filing

Securities and Exchange Commission
Attention: Elizabeth M. Murphy, Secretary
100 F Street, NE
Washington, DC 20549-1090

Re: Venture Capital Fund Exemption
S7-37-10

Ladies and Gentlemen:

We are writing in response to the Commission's request for comments on the proposed rules (the "Proposed Rules") to be promulgated under the Investment Advisers Act of 1940, as amended (the "Advisers Act") in order to implement the new exemptions enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] We appreciate the opportunity to comment on the Proposed Rules.

We recognize the Commission's important role in regulating the activities of private funds and the Commission's desire to protect investors. However, we believe that certain aspects of the Proposed Rules are too restrictive. We ask that the Commission consider the following issues and recommendations prior to final adoption of the Proposed Rules.

I. Expand Venture Capital Fund Exemption

We appreciate the difficulty of the task that the U.S. Congress assigned to the Commission when Congress charged the Commission with, among other things, establishing a definition for venture capital funds. We understand that the Commission needs to distinguish venture capital funds from the broader category of private equity funds in a way that does not create an exemption so broad that it becomes a regulatory loophole. However, we believe that in striving for certainty as to what constitutes a venture capital fund, the Commission has proposed a definition that is too narrow in certain aspects, particularly with respect to the prohibition on debt investments and the definition of a qualifying portfolio company.

1 Release No. IA-3111, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers (November 19, 2010) (referred to herein as the "Release").

As set forth in the Release, Proposed Rule 203(l)-1(a) would define "venture capital fund" as "any private fund that … (2) owns solely: (i) equity securities issued by one or more qualifying portfolio companies, and at least 80 percent of the equity securities of each qualifying portfolio company owned by the fund was acquired directly from the qualifying portfolio company; and (ii) cash and cash equivalents, as defined in Section 270.2a51-1(b)(7)(i), and U.S. Treasuries with a remaining maturity of 60 days or less …."

While the above definition establishes bright lines as to the Commission's view of what a venture capital fund is, we believe that the definition does not accurately reflect how certain venture capital funds currently invest. In addition, sometimes purchases are made from other investors and not directly from the company (*e.g.*, when a selling shareholder invokes its right of first refusal). Furthermore, we believe that the Proposed Rules hinder flexibility and creativity in financing start-up companies and will unnecessarily impede the flow of venture capital to start-up companies. In addition, as noted in the Release, Congress opted to exempt venture capital funds from registration because Congress did not view the venture capital industry as posing the same systemic risk as other aspects of the financial system, finding that venture capital funds "are not interconnected with the global financial system, and they generally rely on equity funding, so that losses that may occur do not ripple throughout world markets but are borne by fund investors alone."[2] Industry participants also noted in testimony before Congress that venture capital funds are exposed to "entrepreneurial and technological risk not systemic financial risk."[3] For these reasons, we do not believe that allowing venture capital funds to continue making the types of investments that they have always made poses a significant risk to the financial system and have accordingly suggested some revisions to the Proposed Rules below.

A. Allow Venture Capital Fund to Make Non-Convertible Debt Investments and Certain Guarantees

While we agree that venture capital funds generally invest in equity securities as such term is defined in Section 3(a)(11) of the Securities Exchange Act of 1934, as amended, and Rule 3a11-1 promulgated thereunder, we believe that venture capital funds need more leeway in crafting financing options for start-up companies, including the ability to make a limited amount of debt investments. As noted in the Release, venture capital is an important source of funding

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2 Senate Report No. 111-176, at 74-5 (2010).

3 Testimony of Trevor Loy, Flywheel Ventures, before the Senate Banking Subcommittee on Securities, Insurance and Investment Hearing, July 15, 2009, at 7 ("Loy Testimony").

for start-up companies or turnaround ventures.[4] These companies generally cannot avail themselves of more traditional forms of financing and rely on venture capital fund sponsors for support. We think that venture capital funds need to be afforded a certain amount of flexibility in order to craft financing solutions that match the needs of various start-ups. Furthermore, testimony cited by the Commission in the Release supports our view that position venture capital investors make non-equity investments.[5]

We recommend that a venture capital fund be allowed to make non-convertible debt investments and/or guarantees in connection with an investment in equity securities if such fund's aggregate debt investments do not exceed 20% of the venture capital fund's portfolio at the time of investment measured as a percentage of the venture capital fund's "regulatory assets under management."[6] We think this threshold will provide venture capital funds with the flexibility to continue operating as they do today without creating a broad exemption that could be exploited by non-venture capital funds.

B. Allow More Flexibility for Secondary Transactions

As noted above, Proposed Rule 203(1)-1(a)(2)(i) requires that for each investment in a qualifying portfolio company, a venture capital fund acquire at least 80% of its holdings of such company's securities directly from such portfolio company. While we agree that venture capital funds generally purchase securities directly from portfolio companies, there are a number of reasons that a venture capital fund would not buy securities directly from a company. For example, the initial owners of the portfolio company might need to exit their investment or obtain some liquidity or the venture capital fund might have a right of first refusal that it wants to exercise in order to protect its investment. For these reasons, we recommend that the 80% limit be applied to the venture capital fund's aggregate holdings and not to its holdings in each qualifying portfolio company.

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4 Testimony of James Chanos, Chairman, Coalition of Private Investment Companies, July 15, 2009, at 4 ("Chanos Testimony").

5 See the Release, at fn 80.

6 We have proposed basing the threshold on "regulatory assets under management" since that is the definition that the Commission has proposed to use for determinations regarding whether an adviser is eligible for an exemption or to register with the Commission and responses on Form ADV should be based on an adviser's "regulatory assets under management," which would include the fair value of any private fund assets (and any other managed accounts), a private fund's uncalled capital commitments, and any proprietary assets (in each case, including assets managed without receiving compensation and assets of non-U.S. clients).

C. Expand Qualifying Portfolio Companies Definition

In addition to allowing venture capital funds to make a de minimis amount of debt investments, we believe that the Commission should broaden the definition of qualifying portfolio company. Proposed Rule 203(l)-1(c)(4) defines qualifying portfolio company as a company that: (i) at the time of any investment by the private fund, is not publicly traded and does not control, is not controlled by or under common control with another company, directly or indirectly, that is publicly traded; (ii) does not borrow or issue debt obligations, directly or indirectly, in connection with the private fund's investment in such company; (iii) does not redeem, exchange or repurchase any securities of the company, or distribute to pre-existing security holders cash or other company assets, directly or indirectly, in connection with the private fund's investment in such company; and (iv) is not an investment company, a private fund, an issuer that would be an investment company but for the exemption provided by Section 3a-7 of the Investment Company Act of 1940, or a commodity pool.

1. Allow De Minimis Investments in Public Companies

While we agree that venture capital investments are generally made in privately held companies, there are times when venture capital investments are made in public companies. For example, the mere fact that a company has gone public does not mean that it is no longer a start-up company. Some start-up companies go public because they either cannot access traditional capital markets or more traditional forms of financing are prohibitively expensive. In addition, public companies in certain industries, particularly research and development intensive industries such as the biotechnology and life sciences sectors, are often still considered venture-stage investments even after going public because of they are still years away from turning a profit. Finally, an existing portfolio company of a venture capital fund might go public but still need some interim financial support from the venture capital fund. In these instances, a venture capital fund might invest in the public company's public securities or in privately issued securities of the public company (*i.e.*, PIPEs).

For these reasons, we encourage the Commission to allow venture capital funds to make de minimis investments in publicly traded companies or companies controlling, controlled by or under common control with a public company. For example, we propose that a venture capital fund's public company investments not otherwise exceed 20% of a venture capital fund's portfolio at the time of investment measured as a percentage of the venture capital fund's "regulatory assets under management." We recommend that this threshold should apply whether the venture capital fund is making an initial investment in a public company or if the investment is a follow-on investment for an existing portfolio company that went public. We believe this threshold is high enough to provide venture capital funds with the flexibility needed to continue making the types of investments currently made but low enough to prevent such funds from posing a systemic risk to the financial system. In addition, we do not think that expanding the Proposed Rules in such a manner would broaden the scope of the venture capital fund exemption so much that other types of pooled investment funds could take advantage of the exemption and avoid registration.

2. *Allow Private Venture Capital Funds to be Qualifying Portfolio Companies*

In addition, Proposed Rule 203(l)-1 would define qualifying portfolio company to exclude any private fund or other pooled investment vehicle. The release concludes, without explanation, that the prohibition on funds of funds is necessary so that a venture capital fund does not "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 rule."[7] We believe that the Proposed Rule should be broadened so that sponsors of funds of funds that do not use leverage do not have to register with the Commission since the sponsors of the underlying funds in which such funds of funds invest either (i) will have to register, in which case the Commission will already have information about the underlying funds, or (ii) will be exempt from registration, in which case the sponsor of a fund of funds should also be exempt.

If the Commission does not want to extend relief to all fund of funds, then we believe that the Commission should revise the definition of qualifying portfolio company to provide that a fund of funds could rely on the exemption if the fund of funds limits 85% of its investments to investments in private venture capital funds that could be exempt under Proposed Rule 203(l)-1 and the fund of funds itself does not use leverage. It is unclear to us why allowing a fund of funds to rely on the exemption is more likely to harm investors or pose a greater risk to the economy than allowing funds to directly invest in venture capital investments. Furthermore, a fund of funds, as with any private fund relying on the venture capital fund exemption, would have to make an exemptive filing so the Commission would have information regarding the fund of funds and its adviser. To the extent the Commission adopts the suggestion above, we believe Proposed Rule 203(l)-1(b) should be revised to extend similar grandfathering relief to eligible funds of funds.

3. *Allow Incurrence of Debt in Connection with Equity Securities Investment*

In connection with our suggestion outlined in Section I.A above regarding venture capital funds being allowed to make a de minimis amount of non-convertible debt investments and make guarantees, the definition of qualifying portfolio company would also need to be broadened since

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7 See the Release, at 35.

it currently prohibits a qualifying portfolio company from borrowing or issuing debt obligations, directly or indirectly, in connection with a private venture capital fund's investment. As noted in Congressional testimony cited in the Release, private equity funds' portfolio companies, particularly portfolio companies of leveraged buyout funds, typically have high debt-to-asset ratios.[8] Therefore, revising the definition of qualifying portfolio companies to allow qualifying portfolio companies to incur a limited amount of debt (*e.g.*, 15% of assets) would not broaden the exemption so much that it would cover the portfolio companies of leveraged buyout funds or other private equity funds that use significant amounts of leverage. As an alternative, as suggested by the Commission in the Release, the Commission could replace the current definition with one based on how the portfolio company uses the proceeds of any borrowing. Such a standard could require that a qualifying portfolio company incur debt only to pay business expenses and fund ongoing operations, not buyout investors.

4. *Relax Restriction on Redemptions, Exchanges and Repurchases*

The Proposed Rule prohibits a qualified portfolio company from redeeming, exchanging or repurchasing its securities or distributing cash or other assets to existing shareholders in connection with a venture capital fund's investment. We understand the Commission's need to structure the venture capital exemption so that leveraged buyout funds cannot rely on it, but venture capital funds frequently structure their investments such that they fund a portfolio company and the portfolio company, in turn, uses a portion of those proceeds to redeem certain existing investors. Since the venture capital fund could, subject to the Proposed Rule's limits, purchase equity securities directly from existing investors, we believe that a portfolio company should have an equivalent right to redeem, exchange or repurchase a limited amount of existing investor's securities. This strict prohibition might also impact a venture capital fund's ability to exit an investment since a qualifying portfolio company might, for example, need to redeem part or all of the venture capital fund's holdings in connection with a merger or acquisition.

II. Provide Relief for Affiliates of a Registered Investment Adviser

In addition to considering our proposals with regard to expanding aspects of the proposed venture capital definition, we request that the Commission take this opportunity to provide additional guidance with respect to the registration requirements for affiliates of registered investment advisers. As a result of the Dodd-Frank Act's repeal of Section 203(b)(3) of the Advisers Act, which exempted investment advisers with fewer than fifteen clients from registration, many advisers will now be required to register as investment advisers unless they

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[8] See Release, at fn 97 (citing sources that private equity portfolio companies typically have approximately 60% debt).

qualify for one of the new exemptions introduced by the Dodd-Frank Act. In addition, some advisers that might not otherwise have to register (or make an exemptive filing) under the Advisers Act may have to register or may be uncertain as to whether they must register because they are affiliated with a registered investment adviser. We reach this conclusion based on (i) the general prohibition, set forth in Section 208(d) of the Advisers Act, which prohibits a person from doing indirectly what could not be done directly under the Adviser Act, and (ii) the Commission's guidance in Richard Ellis, Inc. (No-Action Letter, pub. avail. September 17, 1981) ("Richard Ellis"),[9] which requires, among other things, an unregistered affiliate to be sufficiently independent of a registered investment adviser such that their activities would not be integrated.

We believe that an adviser's investment activities, and not its affiliations, should determine whether the adviser needs to register. For example, if an adviser has common ownership with a registered investment adviser but the majority of each adviser's investment professionals, including a majority of the persons responsible for making investment decisions, do not overlap, then we believe that the adviser should be considered to be sufficiently independent and should not have to register.

Similarly, according to proposed rule 203(m)-1, a private fund adviser would be exempt from registration (i) if such adviser's principal office or place of business is outside the U.S., (ii) such adviser has no client that is a U.S. person except for one or more qualifying private funds and (iii) all assets managed by the investment adviser from a place of business in the U.S. are solely attributable to private fund assets, the total value of which is less than $150 million. We understand this proposed rule to mean that a private fund adviser would be within 203(m)-1 if such advisers investment personnel, including the persons ultimately responsible for the management of such adviser's private fund assets, manage the private fund's assets from outside the U.S., even if certain of such adviser's back and front-office personnel (*i.e.*, finance, operations, legal, investor relations) are located in the U.S. If that same adviser, however, has ownership in common with or shares personnel who make investment decisions for its private funds with an adviser located in the U.S., then the non-U.S. adviser might be uncertain as to whether it has to register simply because of this affiliation.

For these reasons, we believe that as part of the final rules, the Commission should clarify that an adviser should assess its own investment activities, and not those of affiliates, when determining whether the adviser is entitled to rely on an exemption from registration. If that is not the Commission's position, we request that the Commission issue guidance regarding when an adviser otherwise entitled to rely on an exemption from registration must nevertheless

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9 We note that Richard Ellis included a number of factors set forth in the proposing release for Proposed Rule 202-1 (Advisers Act Rel. No. 353, December 18, 1972), which was never adopted.

register with the Commission because such adviser shares owners and/or personnel in common with a registered investment adviser.

As noted above, we understand the difficulty of attempting to distinguish venture capital funds from the broader category of private equity funds so that the venture capital fund exemption does not become a regulatory loophole. We believe that the changes we have proposed would provide the venture capital industry with the flexibility it needs to continue providing support to start-up companies while maintaining the substance of the Commission's Proposed Rules.

We appreciate the opportunity to respond to the Commission's request for comments and we hope that these comments and observations prove useful to the Commission. If you have any questions with respect to the matters raised in this letter, please contact us at 212-710-5231.

Sincerely,

Vedanta Capital, LP