



National Venture Capital Association

September 15, 2004

VIA E-Mail

Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, D.C. 20549-0609  
*rule-comments@sec.gov*

Re: File No. S7-30-04, Registration Under Advisers Act of Certain Hedge Fund Advisers (Release No. IA-2266).

Dear Mr. Katz:

The National Venture Capital Association (NVCA) represents approximately 450 venture capital (and private equity) firms. NVCA's mission is to foster greater understanding of the importance of venture capital to the U.S. economy, and support entrepreneurial activity and innovation. The NVCA represents the public policy interests of the venture capital community, strives to maintain high professional standards, provide reliable industry data, sponsor professional development, and facilitate interaction among its members.<sup>1</sup> Because of the fundamental distinction between hedge funds and venture capital funds, which the SEC has noted throughout its investigation of hedge funds, NVCA has not commented or participated to date in this rulemaking process. Indeed, none of the concerns that have led the SEC to review hedge funds relate to venture capital.<sup>2</sup> Moreover, it is accurate to say that hedge funds do not make venture investments and that generally venture capital funds use none of the myriad investment strategies used by the broad range of investment pools called "hedge funds."

Consequently, NVCA has no position on whether hedge fund advisers ought to register with the SEC. However, we have concerns with the proposed rule and this

---

<sup>1</sup> For more information about the NVCA, please visit [www.nvca.org](http://www.nvca.org).

<sup>2</sup> See generally "Implications of the Growth of Hedge Funds," Staff Report to the United States Securities and Exchange Commission, (September 2003), pp. 1-2.

rulemaking, which these comments on the above captioned Proposing Release (hereinafter “the Release”)<sup>3</sup> address.

### Understanding Venture Capital

Venture capital is a relatively small, highly specialized portion of the private equity investment world. Venture capital funds are true partnerships in which sophisticated limited partner investors (“LPs”) provide capital, on an as-needed basis – up to the level of negotiated commitments – to a fund managed by a venture capitalist general partner, (“VC general partner” or “GP”). Venture capital funds invest in start-up and other privately held operating companies, which promotes economic growth and creates jobs.

Venture capital occupies a unique and valuable role in the U.S. economy. From 1970 – 2003 venture capital funds invested \$338.5 billion dollars into more than 21,600 U.S. companies.<sup>4</sup> Companies that received venture financing between 1970 and 2003 accounted for 10.1 million jobs and \$1.8 trillion in revenue in 2003, representing approximately 9.4% of total U.S. jobs and revenues.<sup>5</sup> These companies registered 6.5% and 11.6% gains in jobs and revenues respectively between 2000 and 2003 while national employment fell 2.3% and U.S. company revenues rose 6.5%.<sup>6</sup> Prominent U.S. companies that received venture financing during their growth phases include: Microsoft, Federal Express, AOL, Apple, Office Depot, Intel, Home Depot, Cisco, Compaq, Genentech, Amgen, and Starbucks. More recent beneficiaries of venture funding include: e-Bay, JetBlue, Seagate, and Google.<sup>7</sup>

Venture capital LPs are highly sophisticated investors who make the long-term, “patient capital” investment required for venture capital. Approximately 90% of venture capital commitments come from sophisticated institutional investors – pension funds, insurance companies, university endowments and foundations. Individuals who become

---

<sup>3</sup> Release No. IA-2266; File No. S7-30-04, Registration Under Advisers Act of Certain Hedge Fund Advisers. (available at <http://www.sec.gov/rules/proposed/ia-2266.htm>); 69 Federal Register 45172 (July 28, 2004). Page cites are to the PDF document posted on the SEC website.

<sup>4</sup> Press Release, National Venture Capital Association, “Venture backed companies outperform peers in 10 industries during U.S. economic downturn, new study shows,” July 20, 2004.

<sup>5</sup> “*Venture Impact 2004: Venture Capital Benefits to the U.S. Economy*,” commissioned by the NVCA and conducted by leading economic analysis and forecasting firm Global Insight (formerly known as DRI-WEFA), p. 2. Global Insight constructed a database of more than 20,000 U.S. companies that received venture capital investment at some point between 1970 and 2003. From this database, Global Insight was able to measure the number of jobs and revenues these companies contributed to the U.S. economy in the years 2000 and 2003. A copy of the study is available at [www.nvca.org](http://www.nvca.org). Information on the study can also be found at [www.globalinsight.com/nvca](http://www.globalinsight.com/nvca).

<sup>6</sup> *Id.*, p. 4.

<sup>7</sup> *Supra*, Note 2.

venture fund limited partners are people with sufficient financial resources and staying power to commit large amounts of capital to illiquid investments for periods of time that can exceed a decade. Such investors have the ability to obtain significant independent financial advice in order to evaluate potential venture investments.

Partnership interests in venture capital funds are almost always negotiated between LPs and GPs. Brokers or other intermediaries, who sell an array of investment vehicles, do not generally market them. Moreover, the formation of a venture capital fund is, in both form and substance the creation of a long-term partnership with a goal of identifying and nurturing young businesses and realizing returns through sale of those businesses at an appropriate time. Into these partnerships VC firms bring capital, management resources and expertise in venture investing.

### Current SEC Regulation of Venture Capital and Hedge Funds

Venture capital and hedge funds are related in the SEC's regulatory regime primarily because the majority of venture capital funds and hedge funds are excluded from SEC regulation under the Investment Company Act by section 3, paragraphs (c)(1) or (c)(7).<sup>8</sup> The majority of venture capital firms do not register with the SEC as investment advisers.<sup>9</sup> Aside from fitting into these same exclusions and generally being organized as limited partnerships, venture funds and hedge funds have little in common. Notwithstanding this narrow nexus with hedge funds, for purposes of commenting on the proposed rule, we assume that the proposed rule would require a significant number of venture capital firms to register as investment advisers but for appropriate exempting language in its definition of "private fund."<sup>10</sup>

Given their substantive dissimilarity, the SEC's stated intention to exclude venture capital and private equity from the proposed registration regime for hedge funds is appropriate. As far as we know, the SEC has neither gathered information on, nor conducted any evaluation addressing, venture capital. Furthermore, the current mix of legislative and regulatory exclusions and exemptions, which exempts most venture firms from SEC registration, has served the purposes of venture capital investors and the important economic purposes of venture capital for many years. Therefore, we assume in

---

<sup>8</sup> 15 U.S.C. § 80a-3(c).

<sup>9</sup> The majority of VC firms manage fewer than fifteen funds, a fact which obviates the question of whether the Advisers Act extends to venture capital firms. NVCA has long believed that the Advisers Act does not necessarily apply to venture capital. The reason is in the nature of the relationship between VC firms and the funds they manage as general partners on behalf of a relatively small group of limited partners. *See generally* VENTURE CAPITAL AND PUBLIC OFFERING NEGOTIATIONS, Halloran, Benton, Gunderson, del Calvo and Kintner, editors, 3<sup>rd</sup> Ed., Vol. 1, 2000 Supplement 5-16. Since the Proposed Rule does not intend to affect venture capital firms, and is designed to make a distinction between hedge funds and venture capital funds in a way that would continue to exempt venture capital firms from even an arguable obligation to register under the Advisers Act, we will not comment further on this point.

<sup>10</sup> Proposed Rule 275.203(b)(3)-2(d)(1) & (2).

Section I of our comments that the Commission has no interest in further regulating venture capital currently, or in the foreseeable future. These comments focus on the critical exempting language in (d)(1)(ii) & (d)(2) of the proposed new rule.

Our second set of comments, under II, below, addresses concerns about whether that assumption is well advised in light of justification offered in this rule proposal, and by members of the Commission.

## I. SPECIFIC COMMENT TO PROPOSING RELEASE QUESTIONS

*Should “private funds” include private equity, venture capital, and other investment pools that are not hedge funds?* Release, p. 49.

As noted above, the substantive differences between venture capital and hedge funds are significant. There is no basis for including them in the same registration regime. Moreover, as noted, the SEC has not developed any record that would justify changing the securities law regime under which venture capital funds and firms are largely exempt from SEC registration and examination.<sup>11</sup> Moreover, hedge funds’ potential impact on public securities markets clearly involves a much higher degree of SEC interest in their regulation.

*Is two years an appropriate time period for redemptions? Are there any other circumstances prompting redemption that need to be excepted from the two-year test? Id.*

As a practical means of exempting venture capital from the proposed rule’s definition of “private fund,” two years is appropriate. Furthermore, it is appropriate and necessary to provide for exceptional redemptions within the two-year lock-up period. It is also critical that the two-year lock-up exception is precise and clear since it is the only provision of the proposed rule that fulfills the Commission’s stated intention to exclude venture capital and private equity. The Commission apparently intends to provide for appropriate relief in circumstances where exceptional redemptions are required. Footnote 140 contains an appropriate policy with respect to this exemption. It states,

[A]n investment pool could offer redemption rights in extraordinary and unforeseeable situations, such as an owner’s death or total disability, or circumstances that make it illegal or impractical for the investor to continue to own the interest in the fund, without becoming a private fund under the new rule.

Release, p. 49, footnote 140 (emphasis supplied.)

The underscored language is the key to a useful and appropriate exception for venture capital and private equity. However, the proposed rule language is ambiguous as to

---

<sup>11</sup> Venture capital firms are, of course, subject to SEC enforcement of the anti-fraud laws and regulation under a variety of state and federal laws.

whether it reflects this policy. We, therefore, recommend a minor change in the rule language, which we discuss in more detail below.

Such “illegal/impractical” contingencies can arise from a number of circumstances. A majority of the capital in venture funds comes from highly regulated sources such as pension funds, insurance companies, financial institutions and tax-exempt entities like college endowments. These investors may need to redeem their investments in order to avoid collateral consequences from the unexpected operation of an existing law or regulation, or the enactment of a new law or regulation. These consequences can impact the fund, the investor or both.

For example, many venture funds are established on the assumption that they are exempt from the myriad requirements of the Employee Retirement Income Security Act (ERISA). However, an investor in a venture capital fund, which is itself subject to ERISA, could cause the entire fund to be subject to ERISA, if, for example, a benefit plan investor held more than 25% of the equity investments in the venture capital fund and no other exemption from ERISA applied. Similarly, a number of ERISA fund investors in a particular venture fund, in the aggregate, could subject the venture capital fund to ERISA. In these rare circumstances, it is necessary that the investor and the fund have the ability to “redeem out” all, or part of, an investment in order to avoid noncompliance with ERISA. Similar contingencies can affect either the venture capital fund or investors in the fund due to legal obligations of highly regulated investors such as non-ERISA pension funds, insurance companies and banks.<sup>12</sup>

Accordingly, in order to accept investments from insurance companies, banks and pension funds, venture capital funds need to provide redemption to investors under some circumstances and, in order to make venture investments, many investors require these types of “extraordinary circumstance” redemption rights. Therefore, it is necessary that the language in the proposed rule reflect the policy stated in Footnote 140.

We recommend that the word “unforeseeable” in 275.203(b)(3)-2(d)(2)(i) be replaced with the word “unforeseen” in order to avoid the risk of an overly narrow interpretation of the lock-up exception. The types of circumstances addressed in venture capital fund limited partner agreements are clearly extraordinary and unforeseen, since such

---

<sup>12</sup> For example, the laws governing state pension funds usually restrict their investments in venture capital and other illiquid investments. Changes beyond the control of such a pension fund can place it in violation of such laws, absent a redemption option. Likewise, laws and regulations governing insurance companies, banks, or non-profit foundations could change, and necessitate a reduction of or exit from venture investments. For example, under merchant banking rules, a bank investor could be required to drastically increase its capital reserves if a venture investment causes the bank to exceed limits on merchant banking activity, making reduction in the venture investment is the only logical choice. Unacceptable changes in tax status can also result from unforeseen developments. Endowments, foreign entities and other tax-sensitive investors need the opportunity to be redeemed out if continued investment would result in a change in U.S. tax status of other serious tax consequences.

redemptions in the first two years of investing are contrary to the long-term purposes of both the fund and its LP investors. However, without benefit of the language in Footnote 140, one could read “extraordinary and unforeseeable” to apply only to circumstances beyond the comprehension of the parties, rather than the types of regulatory and legal complications that sophisticated investors normally seek to address in written agreements, particularly agreements that involve commitments over many years. Therefore, while the Release, as a whole, makes it clear that the Commission intends to create a practical and useful exemption for venture capital and private equity, we believe the rule language itself would more accurately reflect that intent if proposed rule 275.203(b)(3)-2(d)(2)(ii) read: “Events you find after reasonable inquiry to be extraordinary and unforeseen at the time the interest was issued.”

In a similarly technical vein, we believe the Commission should clarify a point raised in Footnote 140 regarding the beginning point of the two-year lock-up period contemplated by the proposed rule. The last sentence of Footnote 140 says: “[t]he two-year redemption test would apply to each investment in the fund, not only to the investor’s initial investment....” Release, p. 46. This statement is clear as to its application to a situation where investment, commitment and tender of funds are essentially simultaneous. However, as the Commission is aware, venture capital investors commit to provide capital at the time they become partners in a fund, but provide capital over a course of years when capital calls are made by the fund GP. Release, p. 47, footnotes 142 & 143. Therefore, for the two-year exemption to work as intended for VC funds there should be but one “investment” that starts a single two-year lock-up period at the time an LP investor commits to provide a specific amount of capital to the fund. We believe that any enacting release should clarify the point that in the venture capital context, an investor’s commitment begins the two-year lock-up period and that tender of funds in response to a capital call on that commitment does not restart the lock-up period.

## II. COMMENTS ON ISSUES RAISED IN THE DISSENT OF COMMISSIONERS GLASSMAN AND ATKINS

*Is there a justifiable basis for distinguishing between the advisers covered by the proposed rulemaking and advisers to venture capital and private equity funds?*<sup>13</sup>

As noted in our earlier comments, there are clear differences between hedge funds and venture capital or private equity funds, which may justify greater regulation of hedge funds. Since the Commission has not stated an intention, or a reason, to further regulate venture capital or private equity, it is incumbent upon the Commission to avoid such regulation. It is also imperative that the Commission avoids creating an easy rationale for future regulation of venture capital or private equity. However, as is pointed out in the Dissent of Commissioners Glassman and Atkins (hereinafter “Dissent”), there is reason to fear that the Proposing Release has created that easy rationale.

---

<sup>13</sup> Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to Proposing Release No. IA-2266, Release, p. 109.

We do not question the sitting Commission's intent to leave the current regulatory regime in place for venture capital and private equity. However, we know that regulation has a tendency to grow and that only Congress has the power to bind future commissions. At least one important regulator has cautioned that this proposed registration regime could well prove inadequate and lead to broader and more intrusive regulation.<sup>14</sup> Absent a clear distinction and more compelling rationale from the Commission for regulating hedge funds and not venture capital or private equity, we do not see this proposal as providing a sound SEC regulatory policy toward venture capital and private equity.<sup>15</sup> We therefore, urge the Commission to follow the recommendation in the Dissent and first explore other means of attaining the goals of this new rule.

NVCA believes that the Release and the proposed rule create a risk of future burdensome regulation on venture capital that outweighs any investor protection benefit that would come from the proposed rule. This risk arises from a number of aspects of the Release.

We are particularly concerned by the Commission's reliance on the growth of pension fund investment in hedge funds as justification for more regulation. Unlike the SEC's 2003 Hedge Fund Report, the Release makes much of the fact that hedge fund investors increasingly include pension funds. Release, pp. 18-21. In Part 1.C., "Retailization of Hedge Funds," the Proposing Release states:

Finally, and perhaps most significantly, in the last few years, a growing number of public and private pension funds, as well as university endowments, foundations and other charitable organizations, have begun to invest in hedge funds or have increased their allocations to hedge funds.

*Id.*, p. 18 (emphasis supplied).

Since pension funds, foundations and university endowments have long been important partners in many venture capital funds, we are concerned with the Release's implication that involvement of these investors with hedge funds is a significant fact in justifying additional SEC regulation. Pension funds, and other institutional investors have been well served by the market forces that created and have largely governed the venture

---

<sup>14</sup> Hedge Funds: Greenspan Expresses Concern over SEC Hedge Fund Proposal, Bureau of National Affairs, Securities Law Daily, (August 30, 2004).

<sup>15</sup> See generally E. Michael Collins, "Creeping Regulation of Private Equity Fund Managers," THT Venture Update, p 3-4 (Summer 2004), available at [www.tht.com/pubs/curPub\\_venture.asp](http://www.tht.com/pubs/curPub_venture.asp). ("SEC staff members and Chairman Donaldson have stated publicly that the SEC does not intend to regulate [all] Private Fund Managers as such; but the lack of a clear delineation by the SEC between hedge funds and private equity funds raises the possibility that, at some point, hedge fund regulation may affect all Private Fund Managers".)

capital business. They are sophisticated investors and can demand significant information and important terms from the firms that organize and manage venture funds. Furthermore, pension fund fiduciaries have the obligation to fully understand the risks and potential rewards of venture capital investing before they expose fund assets to such risks and the resources to obtain expert independent advice.

Therefore, we strongly oppose the suggestion that pension fund investing in a fund represents “retailization” or any other implication that pension funds are in need of greater SEC protection.

Second, the Release’s discussion of the proposed rule’s anti-fraud purpose also fails to establish a clear difference in regulatory policy between hedge funds and other parts of private investing. The Release suggests that a key difference between hedge funds and venture capital or private equity is that “[t]he Commission has developed a substantial record of fraud associated with hedge funds,” Release, p. 47. In the same paragraph it notes that venture funds are “similar to hedge funds in some respects” and distinguishes them on the basis that the Commission has not “encountered significant enforcement problems with advisers with respect to their management of these types of funds.” *Id.* This paragraph concludes “[b]ecause hedge funds are where we have seen a recent growth in fraud enforcement actions, that is where we propose to focus our examination resources at this time.” *Id.* (emphasis supplied.)

Since the 2003 Hedge Fund Report found no unusual incidence of fraud in hedge funds, and the Dissent has shown the weakness of any link between the proposed “solution” of Advisers Act registration and the problems underlying the cited fraud cases, we see little clarity in the Commission’s decision to exclude venture funds from registration and examination “at this time.”

Third, the means by which the Release defines “private funds,” which is the key trigger for registration, is a distinction without a meaningful difference from an investor protection perspective. This is most regrettable. NVCA views hedge funds and venture capital funds as clearly distinguishable, and has no interest in the narrow question of whether or not the SEC regulates hedge funds. We also firmly believe that it is wholly appropriate to exclude VC and private equity from whatever new requirements the SEC might develop for hedge funds. However, we find neither a substantive distinction in the definition of private funds, nor a rationale in the Release for regulating their advisers that could not be applied, for the most part, to other unregulated funds or unregistered private investment firms.

We have studied the words of the Release (pages 46-48) that outline the Commission’s reasons for choosing “redemption rights” as a basis for distinguishing hedge funds from other funds. While we heartily support the effect of this distinction, we find no clear explanation of the “association between these redeemability features and potential abuses that could harm investors,” *id.*, p. 48. It may be that the Commission believes that investors are protected by clarity regarding the illiquidity of private investing, a fact at the heart of venture capital. Perhaps, in addition, the prospect of easy redemption is the type of

September 15, 2004

feature that can cause some investors to make ill-considered investment decisions. However, the Release – in all its ninety-four pages – states no such rationale.

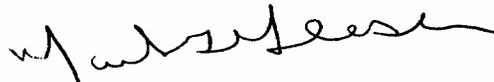
We believe that so fine and so important a distinction as that made in proposed rule 275.203(b)(3)-2(d)(1)(ii) should be clear to anyone who might read it, now or in the future. With the weakness of the facts underlying the Release’s fraud-based rationale, we see neither a distinction nor a regulatory rationale that will deter future commissions that might seek to expand the SEC’s reach into venture capital and private equity.

Fourth, approval of this proposed rule, based on this Release would undermine other important regulatory policies. The Release notes an important distinction between the potential public market impacts of hedge funds versus the negligible effect that any VC fund can have. Such differences can justify different policies. However, as noted, the Release relies too much upon of other reasons for regulating hedge funds that could be applied, now or at some future date, to regulate venture capital funds.<sup>16</sup>

### III. CONCLUSION

NVCA believes that the proposed rule and the Release’s explanation fail to make a clear distinction between hedge funds and venture capital. Therefore, we oppose this rule as creating a serious risk of burdensome new regulation of venture capital in the foreseeable future. Should the Commission proceed with this registration requirement, we strongly recommend the changes described in Section I of this letter as necessary to effect the Commission’s intent to avoid new requirements on venture capital in this proposed rule.

Sincerely yours,



President

---

<sup>16</sup> In addition to the tenuous links of pension fund investing and anti-fraud, the Release attempts to break new ground with regard to the congressional intent underlying the Advisers Act and the definition of “client” in the exemption from registration of advisers of fewer than fifteen client funds. Release, p. 6-7. We are very concerned by the implication in these arguments. Since this rule proposal is not intended to affect venture capital we will not debate the Commission’s statements in the Release regarding this important rule. However, we would strongly disagree with the Release’s characterization of both the legislative intent of the 15-client exception and the common-sense policy reflected in the “fund-as-client” definition were they intended to apply to venture capital firms.