October 9, 2007

VIA E-Mail

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
rule-comments@sec.gov

Re: *Release Nos. 33-8828; IC-27922, (File No. S7-18-07) Revisions of Limited Offering Exemptions in Regulation D.*

Background

The National Venture Capital Association (NVCA) represents the vast majority of American venture capital under management.[1] Venture capital funds provide start-up and development funding for innovative entrepreneurial businesses.

Venture capital plays a special role in fulfilling the purpose for which Regulation D was designed: facilitating capital formation. Indeed venture capital supports the ultimate goal of capital formation by promoting entrepreneurship, stimulating economic growth and creating jobs. These proven results of venture capital investments are a tangible manifestation of the somewhat abstract goal of "capital formation."

[1] The National Venture Capital Association (NVCA) represents more than 480 venture capital firms. NVCA's mission is to foster greater understanding of the importance of venture capital to the US 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, provides reliable industry data, sponsors professional development, and facilitates interaction among its members. For more information about the NVCA, please visit www.nvca.org.

NVCA submitted a comment letter on March 7, 2007 on Release No. 33-8766; IA-2576; File No. S7-25-06, *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, which is referred to as the Private Pooled Investment Vehicle Release in this Release. NVCA's March 7, 2007 comment letter[2] addresses some of the issues regarding qualifications for venture capital fund investors raised in the current Release on Regulation D (hereinafter "Regulation D Release"). Therefore, we incorporate those comments by reference into this letter.

Venture capital funds routinely raise investment capital through a private placement offered under the safe harbor Rule 506.[3] Therefore, NVCA's members are very interested in modifications to Regulation D and support the Commission's efforts to provide additional flexibility for private offerings of securities. We strongly support the Commission's evaluation of its proposed rules in the Private Pooled Investment Vehicle Release (hereinafter "PPIV Release") that would create a separate accredited investor standard for private pooled investment vehicles within the broader context of the capital formation goals of Regulation D.

Summary of Comments

1. The Commission's mandate to promote both investor protection and capital formation is promoted by venture capital. We continue to believe that the policy favoring an exemption for venture capital funds from any higher accredited investor standard for PPIVs is appropriate in light of both capital formation and investor protection considerations.

2. The Rule 501 accredited investor standard for issuers generally should be the Regulation D accreditation requirement for venture capital funds. We urge the Commission to ensure that the new flexibility provided in these proposed changes will be available to venture capital firms to the same extent as all other issuers.

[2] NVCA's comment letter is attached and is also available at http://www.sec.gov/comments/s7-25-06/jdowling7337.pdf. (herinafter the "March Letter").
[3] *See generally*, Michael Halloran, et al., VENTURE CAPITAL AND PRIVATE OFFERING NEGOTIATIONS, Vol. 1 at 3-9 (3rd Edition 2005)

3. The PPIV Release proposal to exempt venture capital from application of the new accredited natural person standard is appropriate and the proposed definition of "venture capital fund" should be modernized to ensure that all venture capital funds are exempted.

4. We support the proposed revisions to Regulation D in this Release that provide greater flexibility for private offerings of securities.

In particular, we support:

- Retention of the current accredited investor standard based on net worth and income
- Addition of the alternative criteria based on investments for qualification as an accredited investor

We also recommend that further consideration be given to reduction of the time lapse required for the Regulation D integration safe harbor to as few as 30 days in the case of an issuer that has shown a clear commitment to a public offering but has withdrawn it because of market conditions.

Detailed Comments

1. The Commission's mandate to promote both investor protection and capital formation is served by venture capital investing.

Venture capital is a proven success in promoting the capital formation process. For the last four decades, venture capital has helped found and build companies, create jobs, and catalyze innovation in the United States. This contribution has been achieved through long-term investment into small, emerging growth companies across the country and across industry sectors. Venture capital has driven small business capital formation through investments in thousands of US companies per year. Venture capital not only invests in these companies, it helps them succeed and drive economic growth.

According to a study conducted by econometrics firm Global Insight, companies that started with venture capital accounted for 10.4 million jobs and $2.3 trillion in revenues in the United States in 2006.[4] According to Global Insight, revenues from venture backed companies represented 17.6 percent of US GDP and 9.1 percent of private sector employment in 2006.[5] As a whole, these companies created jobs at a rate two and one-half times faster than their non-ventured counterparts from 2003 – 2006 and outperformed non-venture companies in job and revenue growth for every industry sector measured.[6] Thus nearly one out of every ten private sector jobs is at a company that was originally venture-backed. The fact that almost 18% of US GDP comes from venture-backed companies[7] is proof of the validity of the venture capital model of capital formation.

Venture investing is also a source of quality economic growth. Capital invested by venture funds has resulted in thousands of successful companies that have pioneered new frontiers. In the biotech sector, venture-backed companies accounted for 54 percent of jobs and 60 percent of revenues in 2006.[8] Companies that received investment capital from venture funds also accounted for 77 percent of all semiconductor jobs, 88 percent of all jobs in the software industry and 94 percent of all jobs in computer and computer peripherals in 2006.[9]

Venture capital has backed such technology innovations as search engines (Google), computer operating systems (Microsoft), online video sharing (YouTube), and online auctions (eBay). Venture capital has supported life saving medical innovations (pacemakers, ultrasound and various drug therapies). It has supported business model innovations such as superstores

---

[4] Testimony of Jonathan Silver, Founder and Managing Director Core Capital Partners, Washington, D.C. before the House of Representatives Committee on Ways and Means, September 6, 2007. *Available at* http://www.nvca.org. For information on prior years, *see* Global Insight, VENTURE IMPACT, THE ECONOMIC IMPORTANCE OF VENTURE-BACKED COMPANIES TO THE US ECONOMY, (3rd Edition 2007), *available at* http://www.nvca.org/pdf/NVCA_VentureCapital07.pdf. *See generally*, 2006 National Venture Capital Association Yearbook, prepared for NVCA by Thomson Financial which includes statistics from the PricewaterhouseCoopers/NVCA MoneyTree™ Report based on data from Thomson Financial.

[5] *Id.*

[6] Testimony of Kate D. Mitchell, Managing Director, Scale Venture Partners, Foster City, CA before Senate Committee on Finance, July 11, 2007. *Available at* **http://www.nvca.org**.

[7] *Supra* note 3.

[8] *Supra* note 4.

[9] *Id.*

(Home Depot and Staples), quality food chains (Whole Foods), and coffee houses (Starbucks). While these companies and innovations are household names today, they were at one time just ideas put forth by unknown entrepreneurs who had little experience in growing a business. The infusion of venture capital dollars and expertise helped turn these ideas into companies. These companies created new markets that have, in turn, fostered the growth of competitors, which have continued the cycle of growth and innovation.

By promoting the strong public policy in favor of job growth, economic development and a higher standard of living for Americans, venture capital supports the Commission's capital formation mission. Therefore, rules that take into account the special role of venture capital in capital formation are completely consistent with the SEC's mission.

Venture capital funds also benefit average investors in many ways. They create operating companies that give public market investors the opportunity to share in significant growth and wealth creation. It is clear that, as much as investors need basic safeguards such as full disclosure, they also need investment opportunities. Literally thousands of companies would not exist today were it not for the venture capital support they received early on. People investing for retirement, to buy a home or to educate their children have benefited greatly from the growth of venture-backed companies like Cisco, Genentech, Outback Steakhouse, Intel, FedEx, Microsoft, Dell, Apple, and the other companies named already in this letter. These companies and many more venture-backed companies have delivered exceptional growth in shareholder value for many years following their initial public offerings and many continue to do so today. Therefore, there is substantial investor benefit that comes from venture capital's focus on taking entrepreneurial ideas to the point of becoming public companies.[10]

2. <u>The Rule 501 accredited investor standard for issuers generally should be the Regulation D accreditation requirement for venture capital funds.</u>

[10] In addition, Venture capital funds themselves have collectively delivered above average returns for our country's pre-eminent institutional investors including public pension funds, university scholarship endowments, and charitable foundations.

Under proposed Rules 216 and 509 in the December 2006 PPIV Release a new, higher "accredited natural person" standard would apply for individuals wishing to invest in private pooled investment vehicles such as hedge funds and private equity funds.[11] We urge the Commission to give serious consideration to the many comments it received in opposition to this new requirement. Furthermore, and most important, we believe that an exception for venture capital funds from any new requirement is appropriate and fully consistent with the SEC's mission and the purposes underlying Regulation D. On both capital formation and investor protection grounds stated in our March Letter and in this letter, venture capital funds should not be subject to a higher accredited investor standard than any other private issuers.

There is little if any need for a higher level of sophistication for investors in private placements of venture capital LP interests than for investments in the private placements of private operating companies. The Regulation D Release's rationale for a new $2.5 million investments test for investments in PPIVs does not apply and, as the PPIV Release proposed, should not apply in the case of venture capital funds. The Regulation D Release gives several reasons for this higher "accredited natural person" test for PPIV. It says that PPIVs involve "unique risks, including risks of undisclosed conflicts of interest, complex fee structures, and the higher risk that may accompany such vehicles anticipated returns." Regulation D Release, p. 47-48. To the extent we understand what the Release intends by these various terms, we do not believe any apply to venture capital funds as compared to other private offerings.[12]

Venture investing is straightforward. Venture funds do not rely on leverage, financial engineering or investments in complex securities to produce their returns. Since venture funds focus on investing in operating companies, the risks involved in venture fund investing are the

[11] The PPIV Release proposed that a natural person wishing to invest in a PPIV, other than an venture capital fund, would be required to meet the Rule 501 accredited investor standard and, in addition, own not less than $2.5 million in "investments" as defined under proposed Rule 509.

[12] The language in the Regulation D Release quoted above, regarding "unique risks, including risks of undisclosed conflicts of interest, complex fee structures, and the higher risk that may accompany such vehicles anticipated returns," appears to come directly from page 17 of the PPIV Release. Footnote 42 on page 17 of the PPIV Release cites the 2003 SEC Staff Study of Hedge Funds in support of the statement that private investment pools "have become increasingly complex and involve risks not generally associated with many other issuers of securities." Since the 2003 Hedge Fund Study found no basis to recommend change in regulation of venture capital funds, there appears to be no factual basis nor a regulatory rationale in either this Release or the PPIV Release for applying a heightened accredited investor standard to venture capital funds.

same as those investors assume in any Regulation D private offering in any start-up company. Venture investments succeed or fail for reasons that the typical investor can readily understand – products, markets, timing, execution, etc.[13] These risks are neither unique nor do they present higher risks regarding anticipated returns.

VCFs use simple fee structures. For the past thirty years, venture funds have followed the same basic compensation formula. Partnership agreements generally grant the fund general partner 20 percent of the fund's profits if the fund is successful. The general partner ("GP") share of profits, or "carried interest," is generally not paid out until limited partner ("LP") investors are made whole on their *entire* investment in the venture capital fund, including in most cases refund of all their management fees. It is not much more complex than a partnership in which two individuals come together to start a business. One partner has the capital; the other has the time and knowledge to run the business. If the business is successful and is ultimately sold, that partnership agreement gives the capital partner 80 percent of the profits and the labor partner 20 percent. Therefore there is no special risk arising from "complex fee structures" for investors in venture capital funds.

The venture capital compensation structure also minimizes -- if it doesn't altogether eliminate – potential conflicts of interest between investors and managers of the fund. Indeed, one of the key ingredients in venture funds is a lock-step alignment of the economic interests of fund investors and venture capitalists. The only annual compensation the typical venture fund GP receives is a management fee, which is typically 2% of committed capital, a number that is established in the partnership agreement. This fee is designed to provide for the basic operations of the fund and no more. The GP is motivated by the potential to benefit from returns that they earn from successfully selecting and nurturing companies to the point where they achieve a "liquidity event" in the form of a public offering or a sale. Only when gains from such events are distributed to fund investors does the GP receive carried interest via the same distribution. This constant alignment of motivation toward liquidity events precludes conflicts between LP

[13] Indeed, the opportunity to invest in a venture capital fund provides a significant measure of diversification as compared to the ability of a typical individual to develop a diversified portfolio of promising entrepreneurial companies. Since diversification is a hallmark of a prudent investment strategy, venture investments could be less risky than many Regulation D offerings.

and GP interests. This alignment obviates any need for heightened investor protection based on "undisclosed conflicts of interest."

Therefore, none of the stated reasons in the Regulation D Release, or the PPIV Release,[14] for establishing a higher PPIV investor qualification standard apply to venture capital. As such, it is appropriate to treat venture capital funds the same as other private issuers.

3. <u>The PPIV Release proposal to exempt venture capital from application of the accredited natural person standard is appropriate and the proposed definition of "venture capital fund" should be modernized to ensure that all venture capital funds are exempted.</u>

As noted already, the Commission's capital formation mandate and the more targeted purpose of Regulation D form a sound policy basis for the treatment of venture capital funds in the same way as other private issuers. Therefore the PPIV Release made an appropriate distinction when it exempted venture capital funds from any heightened standard for private pooled investment vehicles. Not only is the determination appropriate, it is necessary in order to preserve a key ingredient in the success of venture capital funds.

As stated more fully in NVCA's March Letter commenting on the PPIV Release, the vast majority of the capital for venture funds comes from institutional investors that meet Rule 501 standards other than the standard for "natural persons," i.e., individuals. However, the availability of the current Rule 501 accredited investor standard for individuals is critical to the success of venture investing. An accredited investor standard for individuals higher than the current standard would eliminate the ability of some scientists, engineers, academics, entrepreneurs and other "Network Individuals" to invest in venture capital funds. This would eliminate a critical incentive for these key players to assist in the identification and development of investment opportunities for the benefit of the venture fund. Our March Letter provides more

[14] *Supra* note 12.

detail on the importance of retaining the current accredited investor standard for venture capital funds.[15]

Our March Letter also recommends a means of distinguishing venture capital funds from other PPIVs should the Commission establish heightened accreditation standards for such pooled investments. For the reasons detailed in our March Letter, we continue to believe that defining venture capital funds based on the duration of a fund's prohibition of elective redemption rights is a better approach than the one proposed.[16] This approach has the distinct advantage of simplicity over the proposed definition based on the statutory term "business development company" in the PPIV Release. We believe the redemption rights approach will save significant costs that would result from the use of the complex definition in the PPIV Release. Eliminating unnecessary compliance costs is clearly consistent with enhancing capital formation and will inure to the benefit of investors in venture capital funds. Moreover, use of redemption rights to define venture capital for purpose of this proposed exemption would avoid the critical need to amend the proposed definition of "venture capital" in the PPIV Release.

The PPIV Release proposed to exempt venture capital funds from the heightened investor qualification requirements of Rules 216 and Rule 509 based on the definition of "business development company" in the Investment Advisers Act.[17] As discussed more fully in our March Letter, this definition, which was crafted in 1980, is too narrow to encompass the more varied universe of venture capital funds that exists today.[18] Therefore, should the Commission conclude that there is a need for a heightened standard for PPIVs, and also that it needs to define exempt venture capital fund by reference to the "business development company" definition, we strongly recommend that it modify this definition to accommodate both the internationalization of venture capital as well as the growing use of tiered structures in venture capital investing.[19]

---

[15] *See* March Letter, *supra*, note 2 at page 4.
[16] *Id.*, Pages 7-8.
[17] PPIV Release, page 61.
[18] March Letter, *supra*, note 2 at pages 5-6, 8-11.
[19] *Id.*

4. We support the proposed revisions to the limited offering exemptions in the Regulation D Release that provide greater flexibility for private offerings of securities.

As noted above, we support retention of the current accredited investor standard for Regulation D offerings. This definition has served both venture funds and their investors well. We support the Regulation D Release proposal to add an alternative means of qualifying accredited investors based on investments only. While we cannot predict how much this test will be used in lieu of the income or net worth tests in Rule 501, the criteria is as rational as the income and net worth tests in place and should allow greater flexibility for both funds and investors. We do believe however, that a simpler, or a more principle-based definition of "investment" would make the new criterion more useful and could help promote reliance on that standard.

In keeping with the intent of the Regulation D Release, we recommend that the Commission give further consideration to reducing the period of time for application of the integration safe harbor.[20] We are particularly concerned with at least one circumstance.

The key event in the life of many successful venture backed companies is the initial public offering. Of course, the market for IPOs is notoriously unpredictable. It is not uncommon for a company to make a full commitment to a public offering and still be required to stop short of completing the offering because of a change in market conditions. When this occurs, an excellent company can suddenly become very fragile in a number of ways. The ability to access the private market for capital within thirty days of the abandonment of an IPO could enhance the prospects for such a company's continued success. On the other hand, denial of new private capital for even ninety days, as is proposed in the Regulation D Release, could increase the vulnerability of the company. Therefore, we recommend that consideration be given to shortening the integration period to thirty days in at least the circumstances described here in

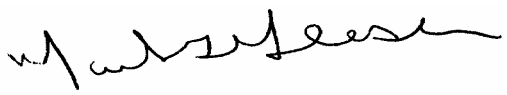
[20] The SEC Small Companies Advisory Committee recommended that the time lapse applicable to the integration safe harbor be reduced to 30 days for all offerings. Final Report of the Advisory Committee on Smaller Public Companies, (April 23, 2006), pages 94-96.

order to provide clarity and certainty for issuers that find themselves in this difficult situation.[21] We are aware that there are concerns regarding abuse of such a rule and would be pleased to assist the staff in developing language to cover this situation while minimizing the risk of abuse.

Conclusion

NVCA appreciates the Commission's efforts to improve the flexibility of Regulation D. We also appreciate the Commission's recognition that venture capital funds play an important role in fostering the goals of Regulation D and should, therefore, be exempt from any heightened accredited investor standard that might be established for private pooled investment vehicles. We appreciate your consideration of our comments and recommendations. If we can be of further assistance in regard to any of these matters, please contact me or Jennifer Connell Dowling, vice president for federal policy at 703 524 2549.

Very Truly Yours,



President

[21] We understand that the Commission attempted to address the problem of a withdrawn public offering in 2001 through Rule 155(c); however, a simpler integration Rule would be far more effective in promoting capital formation in this situation. *See generally*, Charles J. Johnson & Joseph McLaughlin, CORPORATE FINANCE & THE SECURITIES LAWS, (3rd Edition, 2004), pages 549-553.

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Comments on Proposed Rules:
Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles
Release No. 33-8766; IA-2576; File No. S7-25-06 (the "Proposed Rules")

Dear Ms. Morris:

We are pleased to have the opportunity to comment on the Proposed Rules, with a specific focus upon the Proposed Rules' impact on the venture capital industry.

The National Venture Capital Association represents approximately 450 venture capital and private equity firms. In this capacity, we seek to communicate the public policy interests of the venture capital community, promote and maintain high professional standards, provide reliable industry data, sponsor professional development, and facilitate productive interactions among our members.

Summary of Principal Conclusions

1. The Proposed Rules appropriately exclude venture capital funds from the new requirement that a natural person have at least $2.5 million in investments to qualify as an accredited investor (the "New Accredited Investor Rule"). Venture capital funds rely upon broad networks of individual scientists, engineers, academics, entrepreneurs and others ("Network Individuals") to assist in the identification and development of portfolio companies. Allowing Network Individuals to invest in venture capital funds is an important method by which these individuals are incentivized to apply their talents for the benefit of the funds and their portfolio companies. Because many Network Individuals lack the personal wealth to make and hold $2.5 million in investments, application of the New Accredited Investor Rule to venture capital funds would disrupt this incentive mechanism and thereby impair the functioning of the venture capital industry.

2. The definition of "venture capital fund" contained in the Proposed Rules (i) is extremely complex and (ii) as a result of recent trends in the industry, fails to capture many true "venture capital" funds. If this definition were not corrected, the New Accredited Investor Rule would apply with respect to a substantial and growing number

of bona fide venture capital funds, causing significant harm to the venture capital industry.

(i) As an initial matter, we believe it would be simpler and more appropriate to define venture capital funds by reference to their lack of elective redemption rights, similar to the exclusion set forth in Rule 203(b)(3)-1 under the Investment Advisers Act. We suggest that a general prohibition on elective redemptions for a period of 5 years would effectively distinguish venture capital funds from hedge funds and similar pooled investment vehicles.

(ii) If the Commission elects to proceed with a definition of venture capital fund similar to that contained in the Proposed Rules, several technical corrections would be necessary to address the evolution of the venture capital industry in recent years, particularly in connection with the internationalization of venture capital activities and the development of various feeder/conduit structures. These technical corrections are proposed in our detailed comments below.

3. The Proposed Rules appropriately reaffirm investor protections under the Investment Advisers Act's antifraud rules in the context of all types of pooled investment vehicles, whether they be hedge funds, venture capital funds or other types of funds (the "Antifraud Rules"). However, as currently proposed, the Antifraud Rules also introduce enhanced "10b-5" style obligations, with potential consequences that are difficult to predict and could be highly disruptive to the venture capital industry. Even if the Commission were to conclude that enhanced obligations are necessary to address concerns relating to the hedge fund industry, we are unaware of any basis for exposing venture capital funds to such additional obligations and risks. Accordingly, with respect to venture capital funds, we suggest limiting the Antifraud Rules to reinstating the pre-Goldstein *status quo ante.*

Background on the Venture Capital Industry

Venture capital plays a unique and valuable role in the U.S. economy. Venture capital plays a unique and valuable role in the U.S. economy. From 1970-2005 venture capital funds invested $385 billion dollars into more than 23,703 U.S. companies. Companies that received venture financing between 1970 and 2005 accounted for 10 million jobs and $ 2.1 trillion in revenue in 2005, corresponding to 9.0% of US private sector employment and 16.6% of GDP respectively. These companies registered 4.1% and 11.3% gains in jobs and revenues respectively between 2003 and 2005, while national employment grew only 1.3% and U.S. company revenues rose 8.5%. Prominent companies that have received venture financing include: Microsoft, Federal Express, AOL, Apple, Office Depot, Intel, Home Depot, Cisco, Compaq, Genentech, Amgen, Starbucks, Amazon, e-Bay, JetBlue, Seagate, Yahoo, Google and YouTube.

Traditionally, venture capital funds have invested in, and promoted the development of, the most innovative and dynamic sectors of the U.S. economy, including computing and software, internet and telecommunications, biotechnology, pharmaceuticals and medical devices. Today, venture capital funds also are investing in "clean" and "green" technologies, new energy sources, homeland security, nanotechnology, health-care services and more. The venture capital model of accelerating innovation has been so successful that branches of the U.S. government (including the CIA and NASA) have sponsored venture capital funds focused on technologies of special value to the national interest.[1]

Distinguishing Venture Capital Funds from Other Pooled Investment Vehicles

Investment Strategy

Venture capital funds invest directly into young and growing businesses ("portfolio companies") and hold investments for long-term capital appreciation. Unlike certain other pooled investment vehicles, venture capital funds generally do not seek to profit from short-term swings in market prices or financial arbitrage based upon derivative financial instruments. Most venture investments are illiquid for long periods of time and cannot be disposed of in the short term. If a venture capital fund were to use derivative financial instruments, it typically would utilize only those instruments designed to support/complement a long-term commitment to a portfolio company. For example, a fund may acquire an option to purchase additional equity interests in a portfolio company, hedge currency exchange risks associated with a foreign portfolio company, or acquire a put/collar to lock-in capital appreciation generated over a period of years. It would be highly unusual for a venture capital fund to sell short, issue an uncovered call, or engage in similar speculative transactions involving a company with which it has no substantial long-term relationship.

Managerial Assistance

Venture capital funds provide portfolio companies with more than just financial capital. They actively seek to aid portfolio companies through many forms of managerial assistance including: strategic planning; mentoring; validation of technical concepts; recruiting key employees; introductions to key customers, consultants, suppliers and business partners; business development; marketing development; and general business guidance. Considering the primary functions of a venture capitalist (selecting target portfolio companies, consummating investments, assisting portfolio companies, and disposing of portfolio investments), it is quite common for the time spent by a venture

[1] CIA: In-Q-Tel; NASA: Red Planet Capital.

capitalist assisting portfolio companies to exceed time spent on all other functions combined.

Characteristics of Venture Capital Funds Relevant to the Proposed Rules

Investors in Venture Capital Funds

Approximately 90 percent of the capital committed to venture capital funds consists of large commitments (e.g., $1 million or more) from professional, institutional investors.[2]

However, the typical venture capital fund also will admit Network Individuals, who may provide much smaller amounts of capital, but are part of the fund's network of individual relationships and are expected to supplement their capital contributions with personal efforts on behalf of the fund and/or its portfolio companies.

Network Individuals typically are scientists, engineers, academics, entrepreneurs and others who are highly sophisticated in their respective fields, but who lack great personal wealth. The skills that these individuals bring to a venture capital fund are so important that many venture capital firms create specialized "affiliate" or "sidecar" funds for the specific purpose of attracting smaller investments from Network Individuals and thereby incentivizing them to help the firm and its portfolio companies prosper.

Subjecting venture capital funds to the New Accredited Investor Rule would greatly diminish the ability of venture capital funds to tap into the time, energy and skills of Network Individuals. This, in turn, would reduce the overall effectiveness of the venture capital industry as a facilitator of innovation, new companies, new jobs and economic growth.

Furthermore, excluding Network Individuals from venture capital funds under the New Accredited Investor Rule would be particularly inappropriate because the Rule does not provide a good measure of their sophistication. Typically, these investors have the ability to "fend for themselves" that has been the touchstone of the private offering exemption.[3] In many cases, a venture capital fund will seek out a particular Network Individual because that individual is more knowledgeable about a topic relevant to the fund's investments than the managing venture capitalists themselves.[4]

---

[2] 2004 NVCA Yearbook prepared by Thompson Financial.

[3] See SEC v. Ralston Purina Co. 346 U.S. 119 (1953).

[4] For larger venture capital funds, it is rare for an individual investor to be admitted with a small capital commitment unless he or she is a Network Individual. Smaller venture capital funds (that have less access to institutional capital) may admit individual investors primarily to obtain their capital

Angel Investors

In addition to professionally managed venture capital funds, the venture capital industry includes a class of individual investors known as "angel" investors. Angel investors typically make "seed" investments in the range of $25,000 to $500,000 per investment.[5] Because investments in this range often are not practicable for larger venture capital funds, angel investors fill a critical "gap" in financing between founders and professional venture capital. Although many angel investors operate as individuals, others make investments through pooled investment vehicles. Coordinating their investment activities through a pooled investment vehicle allows angel investors to share insights, diversify risks, and amass larger capital reserves to support portfolio companies through multiple rounds of financing.

If angel investors were subject to the New Accredited Investor Rule, it would significantly impair their ability to organize themselves into, or otherwise participate in, funds because many angel investors do not have $2.5 million in investments.[6] Perversely, by making it more difficult to pool their capital, the New Accredited Investor Rule would harm many angel investors by forcing them to make solitary direct investments and deny to them the benefits associated with pooled investment vehicles.

Internationalization of the Venture Capital Industry

In recent years, the venture capital industry has expanded its focus from a few regions in the United States (e.g., Silicon Valley in California and Route 128 in

---

commitments, but due to the long-term nature of the venture capital process and the corresponding long-term commitment made by participants in venture capital funds, those individual investors typically have strong relationships with the managing venture capitalists. We understand that the Commission has noted a growing trend in the hedge fund industry of "retailization" or the expansion of marketing activities to attract investors who may not previously have participated in high-risk investments. However, there is no equivalent trend in the venture capital industry. It would be inappropriate to subject the venture capital industry to the substantial harms described in this letter in order to address marketing trends identified solely with the hedge fund industry.

[5] See MIT Venture Support Systems Project: Angel Investors, MIT Entrepreneurship Center, February 2000, available at <http://angelcapitaleducation.org/dir_downloads/resources/Research_VentureSupportProject.pdf>.

[6] We note that many angel funds are actively managed by all investors. As a result, interests in these funds would not be securities because such interests are not interests in profits "derived solely from the efforts of others" as set forth in SEC v. W.J. Howey Co., 328 U.S. 293. Nevertheless, requiring such funds to rely upon the subjective Howey test could seriously harm their ability to pool their capital and would be contrary to the Commission's policies encouraging certainty in private offerings that underlie the adoption of Regulation D.

Massachusetts) to a large number of regions in the United States and abroad. Today, portfolio companies may be located in Seattle, Washington or Beijing, China. The international aspects of this expansion, in particular, serve U.S. interests in a variety of ways. For example, venture capital funds often help U.S. based portfolio companies develop sales and operations in foreign countries, while helping foreign portfolio companies bring new products and technologies to the United States. The resulting large-scale cross-fertilization of ideas, techniques, technologies and people is widely seen as further accelerating innovation around the globe – and helping to implant U.S. business practices, standards, ethics and ideals into foreign communities.

As a result of this internationalization, many venture capital funds make substantial investments in portfolio companies organized or operated outside the United States, and many venture capital funds are themselves organized in foreign jurisdictions in order to address issues arising under international tax treaties, currency control regimes and other regulatory structures.

As discussed below, certain components of the New Accredited Investor Rule would exclude from the definition of "venture capital fund" many funds participating in this process of internationalization – to the detriment of those funds and U.S. interests.

Feeder/Conduit Structures

As the venture capital industry has matured, so have the structures used to organize venture capital funds. Modern structures include:

1. Venture capital funds investing in other venture capital funds. There are many reasons for this including: (i) large funds with a later-stage focus investing in smaller funds with an earlier-stage focus in order to gain exposure to potential portfolio companies; (ii) established funds investing in newer funds in order to develop personal relationships among venture capitalists that may subsequently lead to a merger of their respective firms; and (iii) funds based on one region investing in funds based in other regions in order to gain insights and/or develop skills.

2. "Funds-of-funds" organized to enable Network Individuals and other smaller investors (who might individually be able to invest in only one or two venture capital funds) to pool their capital and thereby diversify their risk across many venture capital funds.

3. Affiliated venture capital funds co-investing through a single subsidiary fund in order to more efficiently benefit from international tax treaties or to address currency control or other tax/regulatory issues.

Defining Venture Capital Funds by Reference to Elective Redemption Rights

For purposes of the New Accredited Investor Rule, we believe it would be most appropriate to define venture capital funds by reference to the absence of elective redemption rights -- similar to the exclusion of certain funds in the definition of "private funds" set forth in recently adopted Rule 203(b)(3)-1 under the Investment Advisers Act.

Due to the long-term nature of venture capital investments and their general illiquidity, a venture capital fund typically cannot offer elective redemptions during most, if not all, of the fund's term. Occasionally, venture capital funds do permit limited redemptions in extraordinary circumstances, such as death or conflict with an investor's obligations under applicable law.[7] In contrast, a fund that invests in publicly traded securities or other relatively liquid assets generally can permit investor redemptions without undue burden, and periodic redemption rights are common in the hedge fund industry. While it is true that only a real-world test would answer the question with certainty, we believe that a general prohibition on elective redemptions for a period of 5 years would effectively serve to identify venture capital funds and distinguish them from hedge funds and similar pooled investment vehicles.[8]

Defining venture capital funds by reference to an elective redemption feature is preferable to the approach set forth in the Proposed Rules for three reasons. First, the definition in the Proposed Rules is extremely complex, involving multiple layers of definitions and exclusions. This would result in uncertainty and increased costs. Second, ensuring that a venture capital fund complies with the operating restrictions set forth in the Proposed Rules would prove burdensome in practice, again resulting in uncertainty and increased costs. Finally, as discussed in this letter, the complex definition set forth in the Proposed Rules fails to address a variety of issues attributable to the evolution of the venture capital industry in recent years. Even assuming that our proposed technical corrections were adopted, a complex definition would have an increased likelihood of conflict with the future evolution of the venture capital industry.

[7] We note that Rule 203(b)(3)-1 permits extraordinary redemptions.

[8] The key question, of course, is whether hedge funds would evolve away from periodic redemption rights in response to a new rule defining venture capital funds. We believe that a 5-year prohibition on elective redemptions would conflict, as a business matter, with the annual "high water mark" accounting method used by most hedge funds in calculating the fund managers' "carried interest" profit share. Eliminating annual high water mark accounting would be costly for hedge fund managers, so we consider it likely that most hedge fund managers would prefer to operate under the New Accredited Investor Rule. If the Commission were concerned that 5 years would not be long enough to ensure this result, we believe that the venture capital industry would not be unduly burdened by a prohibition on elective redemptions for the longer of (i) 5 years or (ii) 80 percent of the relevant fund's term of existence.

In contrast, the exclusion of venture capital funds in Rule 203(b)(3)-1 under the Investment Advisers Act is simple, compliance is inexpensive, and the likelihood of future conflict is low.

For these reasons, we believe that it would be most appropriate to define venture capital funds by reference to their absence of elective redemption rights -- similar to the definition of "private funds" set forth in Rule 203(b)(3)-1 under the Investment Advisers Act.

Technical Corrections to the Proposed Definition of Venture Capital Fund

If, notwithstanding the foregoing, the Commission elects to proceed with a definition of venture capital funds similar to that contained in the Proposed Rules, the following technical corrections would be necessary to address the evolution of the venture capital industry in recent years, particularly in connection with the internationalization of venture capital activities and the development of various feeder/conduit structures. Failure to include these corrections would cause the New Accredited Investor Rule to apply with respect to a substantial and growing number of true venture capital funds – causing significant harm to the venture capital industry.

Non-United States Portfolio Companies

Section 2(a)(46)(A) of the Investment Company Act requires that an "eligible portfolio company" (*i.e.* a company in which a business development company can generally invest) be organized, and have its principal place of business, in the United States. This requirement is inconsistent with the increasingly international character of the venture capital industry, as discussed above, and (if not modified for purposes of the Proposed Rules) would subject many venture capital funds to the New Accredited Investor Rule.

We would suggest that "eligible portfolio company" be defined for purposes of the Proposed Rules without regard to where the company is organized or conducts business.

Non-United States Venture Capital Funds

Section 2(a)(48)(A) of the Investment Company Act requires that a business development company be organized, and have its principal place of business, in the United States. This requirement is inconsistent with the increasingly international character of the venture capital industry, as discussed above, and (if not modified for purposes of the Proposed Rules) would subject many venture capital funds to the New Accredited Investor Rule.

We would suggest that "business development company" be defined for purposes of the Proposed Rules without regard to where the company is organized or conducts business.

Feeder/Conduit Structures

Section 2(a)(46)(B) of the Investment Company Act excludes investment companies from the definition of an eligible portfolio company. This exclusion is inconsistent with the variety of feeder/conduit structures described above and (if not modified for purposes of the Proposed Rules) would subject some venture capital funds to the New Accredited Investor Rule, while depriving others of the benefits of feeder/conduit structures described above.

We would suggest that "eligible portfolio company" be defined for purposes of the Proposed Rules to include, without limitation, entities that themselves qualify as venture capital funds. Further, this definition should clarify that tiered structures are acceptable (so that, e.g., several tiers of parent vehicles culminating in a single entity that actually invests in portfolio companies can all qualify as venture capital funds).

Text of Suggested Definition of Venture Capital Fund

The following modifications to proposed rule 203.216(b)(2) would satisfy the specific concerns expressed above:

> Venture capital fund has the same meaning as "business development company" in section 202(a)(22) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(22)), except that for purposes of determining whether a company is a venture capital fund –
>
> A. The term business development company as defined under section 2(a)(48) of the Investment Company Act of 1940 shall include a company that does not meet the requirements of subsection A. of section 2(a)(48) of the Investment Company Act of 1940;
>
> B. The term eligible portfolio company as defined under section 2(a)(46) of the Investment Company Act of 1940 shall include a company that does not meet the requirements of subsection A. of section 2(a)(46) of the Investment Company Act of 1940; and

C. The term eligible portfolio company as defined under section 2(a)(46) of the Investment Company Act of 1940 shall include a company that is itself a venture capital fund.

Guidance on the Meaning of "Operated for the Purpose"

Section 2(a)(48)(B) of the Investment Company Act provides that, *inter alia*, a company is a business development company (and hence, a venture capital fund under the Proposed Rules) if it "is operated for the purpose of making investments in securities described in paragraphs (1) through (3) of [Section 55(a) of the Investment Company Act]."

We believe that this language is intended to pick up the 60 percent[9] limitation set forth in the opening paragraph of Section 55(a), but which occurs outside the scope of Sections 55(a)(1)-(3); *i.e.* that a company is a business development company if it is operated for the purpose of making at least 60 percent of its investments in such securities. It would be appropriate and useful for the Commission to clarify this intent in its adopting release.

Many venture capital funds invest through "tiered" structures in which some or all investors are equityholders of a parent vehicle, and a subsidiary vehicle actually makes the investments in portfolio companies. In certain cases, different classes of investors are admitted to the "upper-tier" and "lower-tier" entities. As described above, such structures often are used to obtain the benefits of international tax treaties or to comply with other regulatory requirements. An ownership interest in the subsidiary vehicle held by the parent vehicle is not a security described in paragraphs (1) through (3) of Section 55(a) of the Investment Company Act. We believe that the Commission would not intend that the holding of such interests would be inconsistent with the purposes of a business development company (and hence, a venture capital fund) as described above. It would be appropriate and useful for the Commission to clarify this intent in its adopting release.

Finally, many venture capital portfolio companies are acquired in "stock-for-stock" transactions, where the venture capital fund receives securities of the acquiror. Many, perhaps most, of the securities received in such transactions would not be described in paragraphs (1) through (3) of Section 55(a) of the Investment Company Act because the acquiror is not an "eligible portfolio company." In many cases, the venture capital fund is required to retain such securities for long periods after the acquisition due to limitations imposed by the securities laws or contractual "lock-up" provisions. We believe that the Commission would not intend that the receipt and holding of such securities would be inconsistent with the purposes of a business development company

[9] 70 percent in the text of the rule, but modified to 60 percent per Section 202(a)(22)(A) of the Investment Advisers Act.

(and hence, a venture capital fund) as described above. It would be appropriate and useful for the Commission to clarify this intent in its adopting release.

Responses to Specific Requests for Comments from the Commission

In Release No. 33-8766, the Commission requested comments on a variety of specific issues. We respond to certain of those requests below.

1. *We solicit comment on whether defining venture capital fund with reference to the definition [of business development company] provided in the Advisers Act is appropriate [as compared to the definition in the Investment Company Act].*

While it would be possible to base the definition of venture capital fund for the purposes of the New Accredited Investor Rule upon the definition in the Investment Company Act (instead of the definition in the Investment Advisers Act) we believe that doing so would require substantial modification to the basic definition.

The most important difference between the definition of business development company under the Investment Company Act and that definition under the Investment Advisers Act is the application of Sections 55 through 65 of the Investment Company Act. Among other things, such provisions would:

(a) Require that a venture capital fund register its securities under Section 12 of the Securities Exchange Act and file annual financial statements with the Commission pursuant to Section 13 of the Securities Exchange Act;

(b) Require that a venture capital fund be managed by directors or general partners, a majority of whom are independent of the fund;

(c) Prohibit many common transactions among fund managers and venture capital funds as a result of "conflict-of-interest" rules; and

(d) Impose limitations on a venture capital fund's capital structure and distributions that are inconsistent with the practices of many venture capital funds.

More generally, the definition of a business development company under the Investment Company Act contemplates a publicly traded, highly regulated investment vehicle that has a very different nature than the privately offered, and intensively negotiated, character of venture capital funds.

2. *Would it be more appropriate to define venture capital funds in terms of their investment objective and strategy (e.g., investing in and developing start-up and early phase businesses)?*

As described above, we believe the distinguishing characteristics of venture capital funds are (i) an investment strategy characterized by direct investment in portfolio companies for long-term capital appreciation, and (ii) provision of managerial assistance to portfolio companies. We believe it is appropriate to rely upon these characteristics to define venture capital funds. Subject to the comments set forth above, the Proposed Rules incorporate these concepts by reference to the definitions of "eligible portfolio securities" and "substantial managerial assistance."

3. *[W]ould it be more appropriate to define private investment vehicles to be 3(c)(1) Pools that do not permit their investors to redeem their interests in the pools within a specified period of time ("holding period")? Would such an approach cause most 3(c)(1) Pools to simply extend their holding periods sufficient to avoid application of the proposed rules?*

As discussed above, in order to avoid the unnecessary regulatory complexity and compliance costs of the definition set forth in the Proposed Rules, we believe it would be more appropriate to define venture capital funds by reference to their lack of elective redemption rights -- similar to the exclusion in Rule 203(b)(3)-1 under the Investment Advisers Act.

4. *We particularly solicit the views of commenters on the different types of investments made by venture capital funds, as currently operating in the market, and business development companies, as defined under the Advisers Act. … If we were to adopt a definition of venture capital fund based on either of the statutory definitions of business development company, should we modify that definition to include venture capital funds that invest a significant amount of their assets in foreign securities and other private pools?*

As described above, we believe that the definition of "venture capital fund" should include funds that invest a significant amount of their assets in foreign securities, other venture capital funds, and feeder/conduit entities.

5. *We request comment on whether excluding venture capital funds from the application of the proposed rules is appropriate at all. If so, would applying the proposed definition to them affect their ability to raise capital? Are there other policy reasons for excluding venture capital funds? For example, are there aspects of such funds that make them more appropriate investments for less wealthy investors?*

As described above, application of the New Accredited Investor Rules to venture capital funds would substantially harm the venture capital industry. Venture capital funds would be unable to admit many Network Individuals, thereby impairing the funds' ability to identify attractive investments and provide managerial assistance to portfolio companies. Many angel investors would be unable to organize as collective investment

pools, thus denying them the benefits of collective investing and reducing capital available to finance small businesses in the "gap" between founders and professional venture capital. Moreover, many Network Individuals and angel investors are sophisticated participants in the venture capital industry and able to "fend for themselves," despite not meeting the $2.5 million-in-investments standard under the New Accredited Investor Rule.

For these reasons, we believe it would be highly inappropriate to subject venture capital funds to the New Accredited Investor Rule.

Having made this point, we note that some commentators have suggested that it would serve an investor-protection rationale better to rely upon diversification of investments in lieu of a net wealth or investments test. This approach may eliminate the need to distinguish between venture capital funds and other types of pooled investment vehicles. In principle, we would not object to applying the New Accredited Investor Rule only to those individual investors who wish to invest more than 10% of their net worth into a single pooled investment vehicle, although this approach would require a highly detailed framework to avoid conflicts with the normal operations of venture capital funds. We believe that few venture capital funds would wish to accept more than 10% of the net worth of an investor who has less than $2.5 million in investments. However, we would express caution about setting the standard below 10%. It would be difficult to utilize investments by Network Individuals as an incentive mechanism if such Individuals were not permitted to invest an amount that is, in a real sense, material to them. Furthermore, depending upon how the Commission decides to proceed with respect to the Antifraud Rules (discussed below), a distinction between venture capital funds and other pooled investment vehicles may be required in any event.

The Antifraud Rules and General Concern with Regulation of the Venture Capital Industry

In light of the court's opinion in Goldstein v. SEC,[10] we acknowledge the appropriateness of reaffirming the application of investor protections under the Investment Advisers Act's antifraud rules in the context of all types of pooled investment vehicles, whether they be hedge funds, venture capital funds or other types of funds. However, as currently proposed, the Antifraud Rules impose obligations that go far beyond what is necessary to reaffirm the pre-Goldstein *status quo ante*. Moreover, we are concerned that the Antifraud Rules could presage further burdensome regulatory activity that would include the venture capital industry.

[10] 451 F.3d. 873 (D.C. Cir. 2006).

Expansion of Antifraud Rules

Subsection 206(4)-8(a)(2) of the Antifraud Rules reiterates the obligations of investment advisers set forth in Section 206(4) of the Investment Advisers Act and clarifies that obligations are owed both to the adviser's client (i.e. a fund) and to the investors and prospective investors in that fund. We do not have any criticism of this aspect of the Antifraud Rules.

Subsection 206(4)-8(a)(1), however, would impose additional obligations that go far beyond the pre-Goldstein *status quo ante* . While superficially similar to Rule 10b-5 under the Exchange Act, subsection 206(4)-8(a)(1) on its face appears to cover situations not connected with the purchase or sale of a security.

We are deeply concerned about subsection 206(4)-8(a)(1) for three reasons.

First, we note that there already is a material degree of legal uncertainty over how Rule 10b-5 should be applied to particular circumstances. This uncertainty would be greatly compounded if applied to the general operations of investment funds beyond securities offerings. In other words, subsection 206(4)-8(a)(1) would expose investment funds to significant new regulatory burdens of uncertain scope. This alone would be highly detrimental to the venture capital industry.

Second, and even more important, subsection 206(4)-8(a)(1) would directly interfere with important communications between venture capital funds and their Network Individual investors. As noted above, venture capital funds often work closely with Network Individuals who assist in the selection and mentoring of portfolio companies. In this context, venture capitalists and Network Individuals typically discuss current and prospective portfolio companies in a frank and informal manner. Subjecting these discussions to the diligence and caution that are appropriate for a securities offering would, as a practical matter, prevent many such discussions from ever taking place and thereby substantially burden the ability of Network Individuals to provide their highly valued assistance to venture capital funds and portfolio companies.

Finally, as an essential component of their role as portfolio company mentors, venture capital funds often are in possession of material confidential information relating to portfolio companies that they are prohibited from disclosing to their investors (e.g., information obtained by venture capitalists in their capacity as portfolio company board members). If subsection 206(4)-8(a)(1) were interpreted to require disclosure of such information in ordinary communications with fund investors, fund managers could face an irreconcilable conflict – their duty to protect the confidentiality of portfolio company information versus their duty under subsection 206(4)-8(a)(1) to make greater disclosure.

We are unaware of any basis for subjecting the venture capital industry to these burdens and risks. Even if the Commission determines to adopt subsection 206(4)-8(a)(1) in order to address concerns relating to the hedge fund industry, venture capital funds should be exempt.

General Concern Regarding Regulation of the Venture Capital Industry

The current mix of legislative and regulatory exclusions and exemptions has appropriately balanced the interests of investors and venture capital funds for many years. We believe that further government regulation could substantially harm the venture capital industry without any apparent rationale based on investor protection. Moreover, we are very aware that regulation tends to grow over time.

In this regard, we believe it would be useful and appropriate for the Commission, in its adopting release, to clarify that the use of the term "private investment vehicle" in the Antifraud Rules is not intended to serve as a basis for future regulation of hedge funds and other types of private investment vehicles that "sweeps-in" venture capital funds by default.

Conclusions

We believe that the Proposed Rules generally reflect an appropriate and workable approach for the venture capital industry, but require the modifications described above in order to avoid unintended harm. We would be pleased to provide additional information or clarification upon request.

Yours truly,