S7-18-07 68

National Venture Capital Association

The Honorable Troy A. Paredes
Commissioner
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C.20549

Re: National Venture Capital Association

Dear Commissioner Paredes:

On behalf of the National Venture Capital Association, I would like to congratulate you on joining the Commission. It is my sincere hope that we will be able to work with you toward our mutual goals of investor protection and robust capital formation. NVCA consists of more than 450 venture capital firms which advocates for policies that are favorable to American innovation and entrepreneurship. It also provides objective research data to the public and works to maintain high professional standards for its members.

As I am sure you know, venture capital provides the start-up and development funding for many companies that go public on U.S. stock exchanges. In 2007 alone, venture capitalists invested approximately $30 billion into small, high-risk, emerging growth companies in areas such as life sciences, information technology, homeland security, and clean technology. Until the recent "IPO drought" venture-backed companies have been a major portion of US IPOs on our national exchanges.

NVCA has played an active role in Commission policymaking over the past two decades. In addition to filing comment letters on various rulemakings, we have become personally involved in a number of ways. For example, Ted Schlein, the immediate past chairman of our board, was a member of the SEC's Advisory Committee on Smaller Public Companies. NVCA representatives have served on the Planning Committee of the Annual Small Business Capital Formation Forum for nearly a decade. NVCA also is engaged with not only the SEC, but the FASB, the PCAOB and the IASB on auditing and accounting issues.

In regard to regulatory policy, I would like to make you aware of the venture capital community's concerns with one of the outstanding rulemaking proposals at the Commission: the 2007 Regulation D proposal. You probably know that venture capital funds often raise money through the use of private offerings under SEC Regulation D. The Commission's 2007 proposal to modify Regulation D prompted NVCA to file the comment letter which I have attached. I believe our comment letter, which also incorporates a comment letter filed in an earlier related rulemaking, speaks for itself. I merely wish to call your attention to our comments on accredited investor standards, which are, for venture capital, the most important part of this multi-faceted rulemaking.

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I am enclosing a few of our most recent data publications for your reference. The enclosed information on the current state of the IPO market is of particular concern to NVCA. Should this situation persist, we would hope to meet with you and discuss it.

Again, please accept my best wishes for a rewarding tenure as a Commissioner and NVCA's sincere offer to be an open source of useful data and entrepreneurial perspective on the many policy choices facing the Commission.

Please do not hesitate to contact me or NVCA vice president, Jennifer Connell Dowling, (jcdowling@nvca.org, 703-524-2549) if we can be of assistance.

Sincerely yours,

Mark G. Heesen
President

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.

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[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

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[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. The Rule 501 accredited investor standard for issuers generally should be the Regulation D accreditation requirement for venture capital funds.

[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.

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. 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.

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.

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.

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

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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.

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

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.

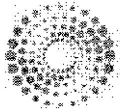
Subsection 206(4)-8(a)(1), however, would impose additional obligations that go far beyond the pre-Goldstein *status quo ante* . While superficially similar to Rule 10b-5 under the Exchange Act, subsection 206(4)-8(a)(1) on its face appears to cover situations not connected with the purchase or sale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



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National Venture Capital Association

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NEWS RELEASE

FOR IMMEDIATE RELEASE

***** THE INFORMATION IN THIS RELEASE IS EMBARGOED UNTIL 12:01 A.M EASTERN TIME ON JULY 1, 2008 *****

NO VENTURE-BACKED IPO'S ISSUED IN THE SECOND QUARTER OF 2008

IPO Drought Creates Capital Market Crisis for Start-Up Community

New York, New York, July 1, 2008 – For the first time since 1978, there were no venture-backed Initial Public Offerings (IPOs) in the second quarter of 2008 according to the Exit *Poll report by the National* Venture Capital Association (NVCA) and Thomson Reuters. The absence of any offerings this quarter follows an exceptionally slow first quarter when only 5 venture-backed companies went public. This number is a fraction of the first half of 2007 when 43 companies went public. According to the NVCA, the situation is concerning enough to be characterized as a capital markets crisis for the start-up community.

"Venture-backed companies that successfully enter the public markets represent a critical job creation engine for the United States economy, and that engine has completely shut down," said Mark Heesen, president of the NVCA. "We need to put regulators, legislators, presidential candidates, and the private sector on notice that this situation represents a serious problem that will have long reaching economic implications if not addressed. We view this quarter as the 'the canary in the coal mine'."

During the week of June 23, the NVCA surveyed its membership on the current IPO drought. The 660 plus responses that were received from venture capitalists across the country reinforced the concerns of the association, specifically:

- 81 percent of venture capitalists do not see the IPO window opening in 2008.
- Two-thirds of venture capitalists believe that venture-backed companies are less likely to want to go public today than they were 3 years ago.
- The three largest factors to which venture capitalists attribute the current IPO drought are:
    - Skittish investors (77 percent)
    - Credit crunch/mortgage crisis (64 percent)
    - Sarbanes Oxley regulation (57 percent)

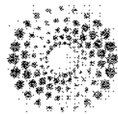
- Only 8 percent of venture capitalists characterize the current IPO drought as "not critical" to the future health of the venture capital and entrepreneurial communities.

Dixon Doll, co-founder of Menlo Park based DCM and current NVCA chairman remarked, "While we clearly recognize that the IPO drought is being driven largely by a weak economy, there are other systemic factors that are making the IPO exit less attractive for high quality venture-backed companies. Our government and the private sector should be doing all that it can to encourage these innovative, high quality companies to enter the public markets and grow from there. The acquisition will always be an attractive and viable exit path for venture-backed companies, but the public offerings create visible, long term economic growth. Imagine the implications if Genentech, Google, or Intel decided to forgo a public offering and become acquired because the public market option was unappealing. The "next Genentech or Google" may be making that decision right now. The best choice for that company should also be the best choice for our capital markets system and our economy."

Companies that were once venture-backed but are now public account for 10.3 million jobs and 18 percent of US GDP, according to a 2007 Global Insight Report.

The NVCA has been advocating for Sarbanes Oxley reform for several years as the cost for small companies to go public has risen dramatically under the law. This cost, coupled with a decreased market appetite for smaller cap companies, a lack of analyst coverage, and a lower investor appetite for technology stocks, has raised the bar considerably for venture-backed companies hoping to go public. The median age of a venture-backed company from founding date to IPO hit a 27 year high in 2007 at 8.6 years.

As of 6/30/2008, there were 42 venture-backed companies that have filed for an initial public offering with the SEC and are currently "in registration." This number is down 40 percent from its 3-year high of 72 companies in Q3 2007.



NVCA
National Venture Capital Association

Venture-Backed Liquidity Events by Year/Quarter, 2001-2008ytd

Quarter/Year	Total M&A Deals	M&A Deals with Disclosed Values	*Total Disclosed M&A Value ($M)	*Average M&A Deal Size ($M)	**Number of IPO's	Total Offer Amount ($M)	Average IPO Offer Amount ($M)
2002	**318**	**152**	**7,916.4**	**52.1**	**22**	**2,109.1**	**95.9**
2003	**290**	**122**	**7,721.1**	**63.3**	**29**	**2,022.7**	**69.8**
2004	**339**	**186**	**15,440.6**	**83.0**	**93**	**11,014.9**	**118.4**
2005-1	81	45	4,351.9	96.7	10	720.7	72.1
2005-2	81	34	4,725.0	139.0	10	714.1	71.4
2005-3	101	48	18,056.0	376.2	19	1,458.1	76.7
2005-4	87	39	2,594.0	66.5	18	1,592.1	92.2
2005	**350**	**166**	**29,727.0**	**179.1**	**57**	**4,485.0**	**78.7**
2006-1	107	52	5,607.5	107.8	10	540.8	54.1
2006-2	105	40	4,018.5	100.5	19	2,011.0	105.8
2006-3	94	42	3,894.8	92.7	8	934.2	116.8
2006-4	62	26	5,616.8	216.0	20	1,631.1	81.6
2006	**368**	**160**	**19,137.6**	**119.6**	**57**	**5,117.1**	**89.8**
2007-1	82	29	4,540.3	156.6	18	2,190.6	121.7
2007-2	87	36	3,972.3	110.3	25	4,146.8	165.9
2007-3	100	52	10,810.0	207.9	12	945.2	78.8
2007-4	86	43	9,084.1	211.3	31	3,043.8	98.2
2007	**355**	**160**	**28,406.7**	**177.5**	**86**	**10,326.3**	**120.1**
2008-1	70	28	3,602.4	128.7	5	282.7	56.5
2008-2	50	14	2,397.3	171.2	0	0.0	n/a
2008	**120**	**42**	**5,999.7**	**142.9**	**5**	**282.7**	**56.5**

Thomson Reuters & National Venture Capital Association

*Only accounts for deals with disclosed values

**Includes all companies with at least one U.S. VC investor that trade on U.S. exchanges, regardless of domicile.

Mergers and Acquisitions Volume Declines

In the second quarter of 2008, 50 venture-backed M&A deals were completed, 14 of which had an aggregate deal value of $2.4 billion. M&A volume of 120 transactions in the first half of 2008 was down 28 percent from the first half of 2007 when 169 transactions were completed. The average disclosed deal value for the quarter was $171.2 million.

The Information Technology sector dominated the venture-backed M&A landscape, with 36 deals and a disclosed total dollar value of $1.8 billion. Within this sector, Computer Software and Services companies accounted for the bulk of the target companies, with 15

transactions across this sector subset. Non-High Technology saw the next highest level of activity with 11 deals and a combined disclosed value $536.9 million. Finally, Life Sciences deals accounted for 3 exits with disclosed value for one transaction of $53.2 million.

Venture-Backed M&A Industry Breakdown

		Q2 2008		
	Industry	Number of Venture-Backed M&A deals	Number of Venture-Backed M&A deals with a disclosed value	Total Disclosed Venture-Backed Deal Value ($M)
Information Technology	Communications and Media	6	2	394.3
	Computer Software and Services	15	3	443.0
	Internet Specific	7	3	963.0
	Semiconductors/Other Elect.	7	1	6.9
	Computer Hardware	1	-	-
	TOTAL	36	9	1,807.2
Life Sciences	Biotechnology	1	1	53.2
	Medical/Health	2	-	-
	TOTAL	3	1	53.2
Other	Other Products	6	2	475.5
	Consumer Related	2	1	44.0
	Industrial/Energy	3	1	17.4
	TOTAL	11	4	536.9
	TOTAL	50	14	2,397.3

Source: Thomson Reuters & National Venture Capital Association

The largest transaction of the quarter was the acquisition of social networking site operator Bebo, Inc. by AOL LLC. The transaction, valued at $850 million, was completed in May.

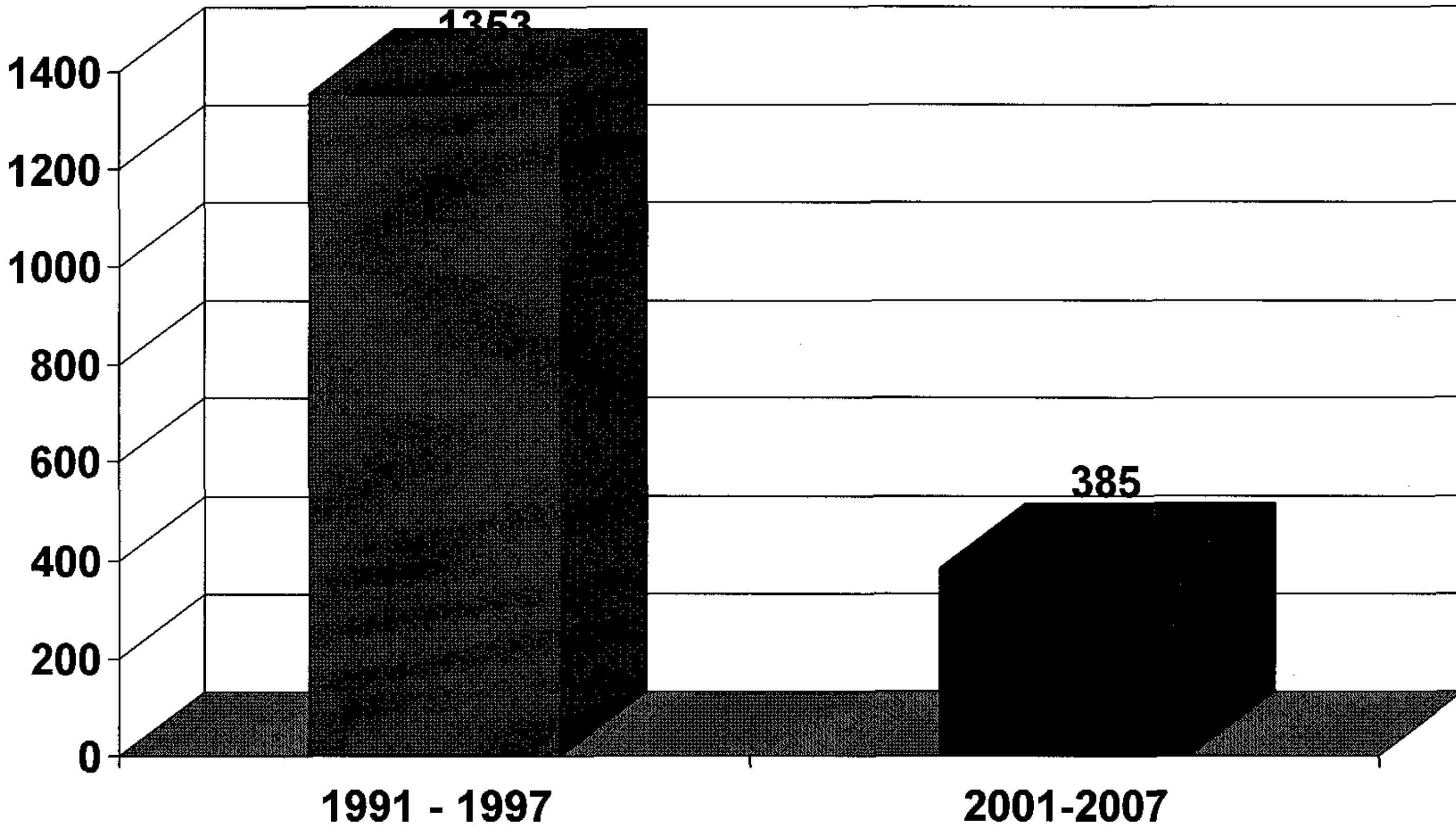
Deals bringing in the top returns, those with disclosed values greater than four times the venture investment, accounted for 55 percent of the total compared to 52 percent last quarter. Those deals returning less than the amount invested accounted for 27 percent of the quarter's total, compared to 26 percent of the total last quarter.

ALL MATERIALS CONTAINED WITHIN ARE EMBARGOED UNTIL 12:01 A.M. ON TUESDAY, JULY1, 2008

Capital Markets Crisis for the Start-Up Community

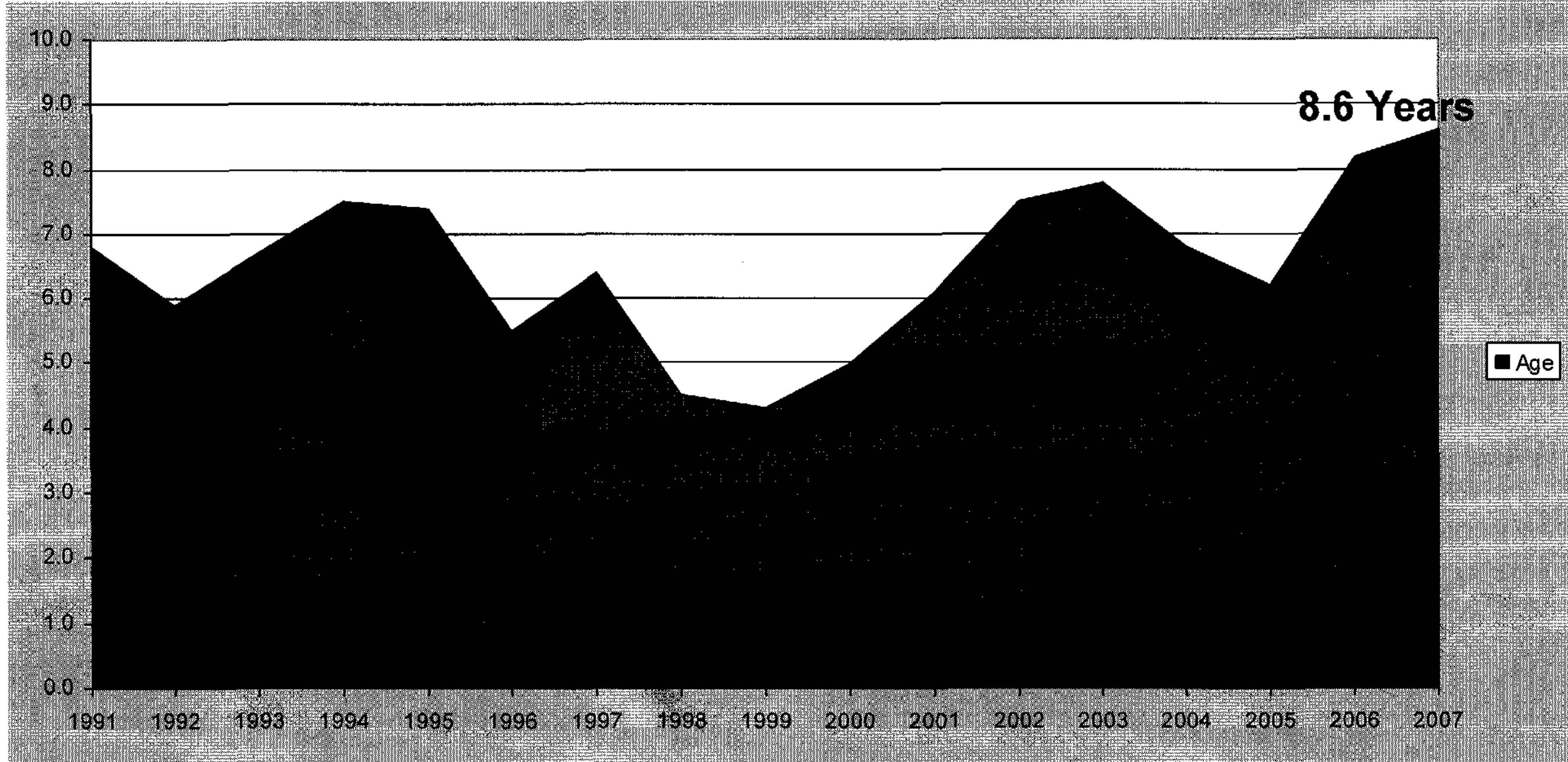
July 1, 2008

Venture-backed IPOs
1990's vs. 2000



Source: Thomson Reuters & NVCA

Median Age of a Venture-Backed Company at IPO

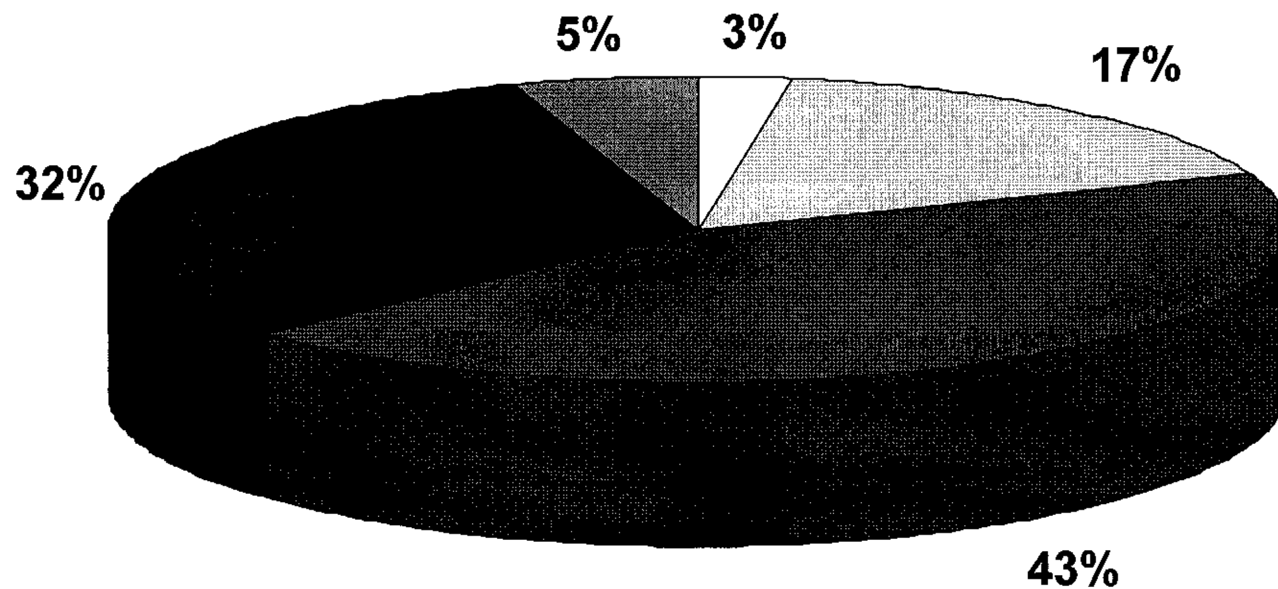


Source: Thomson Reuters & NVCA

NVCA Survey

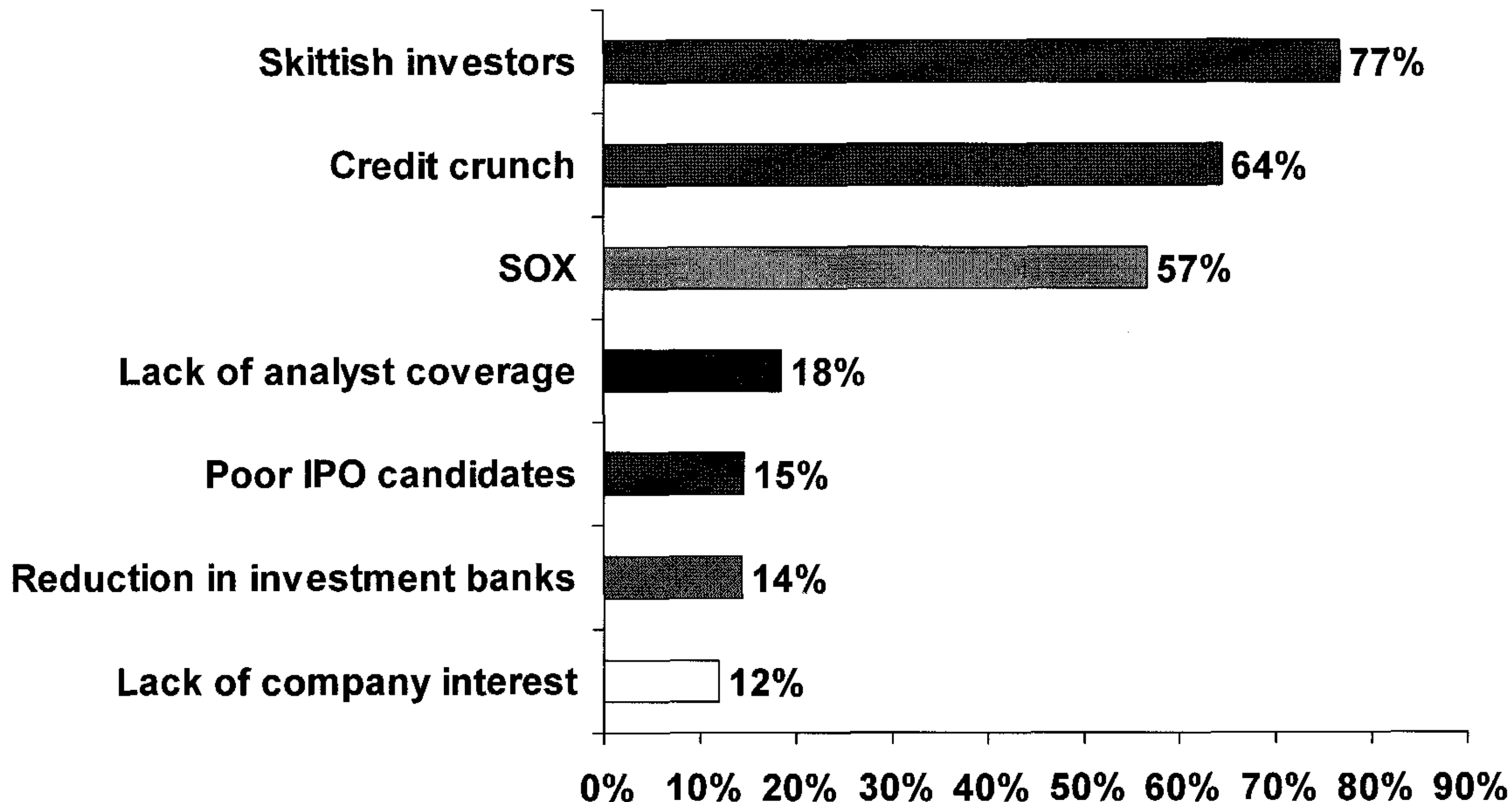
- Polled NVCA membership
- Week of June 23, 2008
- 662 responses

When do you see the IPO window re-opening?



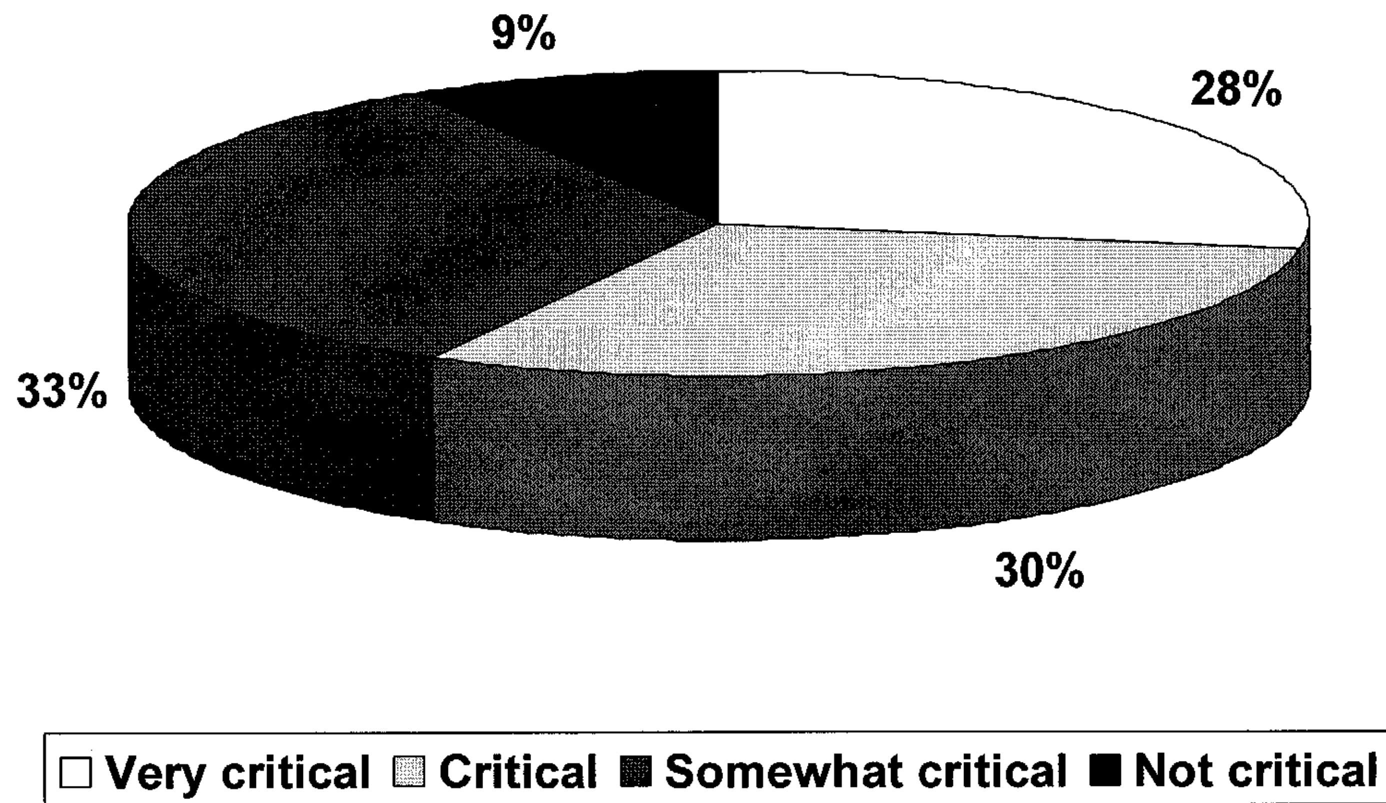
Source: NVCA

What are the three largest factors you attribute to the current IPO drought?



Source: NVCA

How do you view the current IPO drought relative to the future health of the VC and entrepreneurial communities?



Source: NVCA