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Via email to: rule-comments@sec.gov

Elizabeth M. Murphy
Secretary
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Release No. IA-3111 (Nov. 19, 2010)
(Reference: File No. S7-37-10)

Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. IA-3110 (Nov. 19, 2010)
(Reference: File No. S7-36-10)

Dear Ms. Murphy,

We respectfully submit this letter in response to the request of the Securities and Exchange Commission ("SEC") for comments with respect to the two above-referenced proposing releases. Given the close interrelation of the two releases, we have submitted this single comment letter to be filed with respect to both rulemaking proposals.

We are writing on behalf of the Berkeley Center for Law, Business and the Economy ("BCLBE") which is the hub of Berkeley Law's research and teaching on the impact of law on business and the U.S. and global economies. Part of the University of California at Berkeley, BCLBE serves as a hub for rigorous, relevant, empirically based research and education on the interrelationships of law, business, and the economy. We endeavor to inform students, policymakers and the public of the implications of this innovative work to promote positive outcomes on business operations, economic growth, and market efficiency. Our interdisciplinary approach to basic research, timely policy research, curriculum innovation, and public education empowers current and future leaders in business, law and policy to tackle the most pressing problems of today and tomorrow. Additional information regarding BCLBE may be found on our website at http://www.law.berkeley.edu/bclbe.htm.

Introduction

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1] The principal objective of Dodd-Frank is to address certain causes of the systemic credit crisis which had rocked the American financial sector in 2008.

Registration of Private Funds

One notable aspect of the legislation in this regard is its significant expansion of the scope of the Investment Advisers Act of 1940 (the "Advisers Act") to broadly require advisers to private funds, such as hedge funds and private equity funds, to register with the SEC as investment advisers. Heretofore, many such advisers had been able to rely on an exemption from registration for advisers which advise fewer than 15 funds and meet certain other criteria.

Venture Capital Exemption

In adopting this expanded registration requirement, however, the drafters of Dodd-Frank recognized that venture capital ("VC") funds had not played a contributory role in the 2008 financial crisis, and that it would be counterproductive for the American economy as a whole to impose significant regulatory burdens upon VC funds as an ancillary byproduct of the statute's focus on private funds more generally. Accordingly, although Dodd-Frank broadly requires registration by the advisers to all private funds which rely on exceptions from the definition of "investment company" under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "'40 Act"), Dodd-Frank sensibly specifically provides that the advisers to VC funds not be subject to this registration requirement.[2]

SEC Implementing Releases

Pursuant to the statute's directive to adopt implementing regulations, the SEC on Nov. 19, 2010 issued two proposing releases relative to these provisions of Dodd-Frank. While one of these two releases addresses and implements the specific registration exemption for VC funds (the "Exemption Release"),[3] the other imposes a background non-registration reporting requirement

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[1] Pub. L. No. 111-203, 124 Stat. 1915.

[2] In the SEC Open Meeting at which the agency proposed implementing regulations in this regard, discussed *infra*, SEC Chairman Mary Schapiro indicated that two cardinal considerations gave rise to the venture capital exemption, namely that VC funds do not use leverage to make their investments, and the nature of the startup operating companies in which they invest. VC funds are not interconnected with other parts of the financial industry in a manner which gives rise to systemic risk concerns. *See* SEC Chairman Mary L. Schapiro, Remarks at Open Meeting of the SEC (Nov. 19, 2010) [hereinafter Proposing Open Meeting], *available at* http://www.sec.gov (follow "Webcasts" hyperlink, then follow "SEC Open Meetings" hyperlink, then follow "Webcast Archive" hyperlink for Fri., Nov. 19, 2010).

[3] Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, SEC Release No. IA-3111 (Nov. 19, 2010) [hereinafter Exemption Release].

on VC funds (the "Reporting Release").[4] This letter offers comment and suggestions with respect to the SEC's proposed rulemaking.

Flexibility for Bridge Financings and Venture Debt Funds

One area where the Exemption Release may not completely succeed in carving VC funds out from its registration requirement is with respect to so-called "venture debt" funds. This results from the release's proposed definition of "venture capital fund" as one which, among other things, invests only in equity securities, with the sole exception of cash, cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less.[5]

The term "equity securities" is admittedly fairly broad, including not only common and preferred stock but also warrants and other securities convertible into common stock.[6] For example, the release discusses the case of a bridge financing in anticipation of a future round of venture capital investment.[7] In such a case, a bridge investment "in instruments that are ultimately convertible into a portfolio company's common or preferred stock at a subsequent investment stage" would constitute an investment in equity securities.[8]

If, however, a venture debt fund were to receive at the time of its funding a portfolio company a debt instrument that by its terms is not exercisable for or convertible into an equity security, even though it might very well ultimately be anticipated that a voluntary cancellation of such debt instrument in exchange for equity might take place in a subsequent financing round, the venture debt fund would destroy its exemption from registration as a VC fund. Such could occur, for instance, if a fund were to receive in return for its investment in a portfolio company a straight note coupled with a warrant "kicker" designed to provide potential upside – the warrant would qualify as an equity security, but the straight note would not.

Moreover, this potential problem would apply not only to venture debt funds, but to any VC fund that, although it ordinarily invests solely in portfolio company preferred stock, provides bridge financing on terms where it receives a nonconvertible debt instrument in connection with the bridge.

Explicit Equity Conversion Provisions

A potential workaround to address this aspect of the proposed rules would be consistently to insist upon equity conversion features in all debt instruments to be received by a fund, be it a standard VC fund or venture debt fund. Nonetheless, this element of the rule might create a trap

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[4] Rules Implementing Amendments to the Investment Advisers Act of 1940, SEC Release No. IA-3110 (Nov. 19, 2010) [hereinafter Reporting Release].
[5] Proposed Rule 203(l)-1(a)(2).
[6] Proposed Rule 203(l)-1(c)(2) indicates that the term "equity securities" shall have the same meaning as in Section 3(a)(11) of the Securities Exchange Act of 1934, which includes inter alia any stock or similar security, any security convertible into such a security, or carrying any warrant or right to subscribe to or purchase such a security, or any such warrant or right.
[7] *See* Exemption Release, *supra* note 3, at 22-23.
[8] *Id.* at 23.

for the unwary, and might have the effect of unnaturally forcing transactions to reflect certain forms and to contain certain provisions which they might not otherwise do.

Should the Nature of the Instrument Received Be Determinative?

From a broader policy perspective, it would appear that precise nature of an instrument received from a portfolio company is not necessarily the key inquiry when it comes to an analysis of a fund's potential relationship to systemic risk.

It might be argued, for example, that an institution which may be obligated to return capital to its own depositors or investors on a fairly short-term basis raises potential systemic risk considerations – if faced with sudden demand for such a return of capital, such an institution may in turn either shut off its provision of further funding to other parties or, more significantly, recall monies previously advanced (as might occur in the case of a bank facing significant demand from depositors), or might attempt to rapidly liquidate assets in order to satisfy such demands (as might occur in the case of a hedge fund facing significant redemption requests). This natural, almost automatic transmission of financial distress from one entity to the other is one of the principal routes of infection in a financial crisis. One domino topples the next.

The reason a VC fund does not raise concerns of this type is that a VC fund typically is not obligated to return capital promptly to its own investors, and does not use leverage to make its investments. Typically, investors are contractually committed to make contributions to a fund over the course of many years and have no significant rights of redemption. This means that a VC fund generally will not become subject to a credit squeeze which it will be required by necessity to pass along to portfolio companies. A VC fund does not act as a domino in a chain.

The policy implication is that if a fund, even one characterized as a venture debt fund or which otherwise receives a straight debt instrument in connection with an investment, is not itself subject to short-term demands on its own capital from its own investors, or from lenders, that is the critical inquiry from a systemic risk perspective. Unless a venture debt or other VC fund holding such a straight debt instrument issued by a private entity has the ability to call the debt on its own initiative and on its own discretion in the absence of default by the portfolio company, it is not clear that the character of the instrument as straight debt materially influences the systemic risk analysis. Because the character of the instrument held by the VC fund is not the key inquiry, the addition of a requirement to the definition of VC fund that the fund only invest in equity securities arguably unnecessarily restricts such funds' freedom of action and flexibility in structuring transactions.

Limiting the Suggested Carveout

If after consideration the SEC remains concerned that providing more flexibility to VC funds as to the form of instruments to be received from portfolio companies might create a loophole that could be exploited in a manner conducive to generation of systemic risk, two more limited approaches might be suggested. First, the additional flexibility might only extend to straight, nonconvertible promissory notes rather than any other kind of financial instrument. Second, bridge financings by a standard VC fund could easily be differentiated from the activities of a venture debt fund – the SEC might thus permit the receipt of straight promissory notes from a portfolio company in which a VC fund has already made, or anticipates making, an equity investment.

The Managerial Guidance or Control Requirement

One aspect of the proposed rules is a requirement that a VC fund, with respect to each portfolio company, must either offer to provide (and if accepted, does so provide) significant guidance and counsel concerning the management, operations or business objectives and policies of the portfolio company, or must control the portfolio company.[9]

This requirement is not necessarily problematic provided that it is construed in a manner sufficiently flexible to take account of and avoid interference with the typical patterns of VC engagement with portfolio companies. The SEC's final adopting release should contain guidance along these lines such that a more restrictive interpretation of the rules does not come to prevail in a manner inconsistent with the current typical range of relationships betwen VC fund managers and their portfolio companies.

The Typical Relationship Between a VC Fund and a Portfolio Company

In the typical VC investment, the VC fund will receive shares of a specified series of preferred stock. In connection with the investment, the VC fund, the portfolio company and certain other parties will typically enter into various other contractual arrangements as well. A classic "plain vanilla" investment package would consist of terms and conditions set forth in the portfolio company's certificate of incorporation (charter) and bylaws, as well as in a stock purchase agreement, an investor rights agreement, a right-of-first-refusal and co-sale agreement, and a voting agreement.

Under that package of terms and conditions, a VC fund will typically, either as an individual series, or along with other series on a pooled basis, enjoy veto rights with respect to certain proposed corporate actions, such as mergers, issuances of additional securities, etc. The fund may or may not have a right to have one of its own representatives elected to the portfolio company's board of directors. In the absence of such a right, the fund might or might not enjoy board observation rights, pursuant to which a representative of the fund could attend and observe at board meetings but would carry no vote as a board member.

In the typical situation, over the life of a portfolio company as it moves from inception toward either being acquired or going public, several different VC funds will have invested in the company, with the different funds enjoying different packages of rights depending on which financing round they invested in. It is often the case that not all VC funds that have invested in a company will enjoy a board representation right, and of those without board representation rights, not all will enjoy board observer rights. It is often through a position on the board of directors, however, that a VC fund typically engages most directly with management to provide

[9] Proposed Rule 203(l)-1(a)(3).

guidance and counsel concerning the management, operations and business objectives of the portfolio company. Those board meetings are where the primary discussions concerning the business typically take place, where advice is offered, where offers of assistance with personal contacts and relationships are made, etc. Yet those VC funds which have taken a smaller, second chair position in a portfolio company are nonetheless very much acting as VC funds, providing venture capital to a fledgling private business.

Stepping back to view the matter from a policy perspective, the issue of whether or not a VC fund is actively engaged in advising the management of a portfolio company is not the core inquiry from a systemic risk perspective. It is admittedly often a characteristic of VC funds that they are so engaged, but it is by no means universally the case that a VC fund's investment is accompanied by that kind of direct involvement. The SEC has presumably focused upon this characteristic as one way to distinguish VC funds from other types of private funds, but it is not vital to either the analysis of systemic risk or to the value to the American economy of venture investing. What counts from the fundamental policy perspective is that VC funds are not likely to serve as dominos in a credit squeeze chain, and the innovative, startup character of the portfolio companies in which they have invested.[10] The provision of seed capital to startup businesses generates value to the American economy, whether or not that investment is accompanied by active managerial advice or involvement.

Managerial Guidance

It would accordingly be appropriate for the proposed managerial guidance and counsel requirement to be interpreted in a broad and generally nonrestrictive manner. The SEC's rule, either through explicit text or through interpretive statements in the final adopting release, should make clear that a VC fund that is not represented on the board (and may not even have a board observer right) can nonetheless satisfy the guidance and counsel requirement through good faith offers to provide those services to portfolio company management, even in circumstances where those offers are not likely to be accepted. In the absence of such guidance the rules could have a distortionary impact on the structuring of VC investments, impede development of new or smaller VC funds that are more likely to have minority investment positions in VC investment rounds, and generally reduce the availability of venture capital with no corresponding reduction in systemic risk.

Control

As to the control prong of the proposed requirement, the SEC should make clear that having a single representative on the portfolio company's board of directors is sufficient to satisfy the definition of control.

In the Exemption Release, the SEC mentions that instructions to Form ADV provide a presumption of control if a person has the power to vote 25% of the portfolio company's voting securities.[11] There are, however, many cases in which a legitimate VC investment has been

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[10] *See* Chairman Schapiro's remarks, *supra* note 2.
[11] *See* Exemption Release, *supra* note 3, at 40.

made where the VC will not meet that voting percentage threshold. This is particularly true with respect to early VC investors whose relative percentage ownership is slowly diluted over time by subsequent funding rounds in which other VCs invest in the portfolio company.

Furthermore, the pattern of voting rights in the typical venture-backed portfolio company is not that of a single, unified and uniform class of voting shares. Rather, there are typically highly customized voting rights which apply to different situations and to different classes and series of stock. Application of a single percentage threshold will have difficulty capturing the complexity of actual voting relationships in such portfolio companies. A VC fund enjoying far less than 25% of the total as-converted voting power of a portfolio company's total outstanding capital stock may nonetheless enjoy significant series-specific veto rights over a variety of major corporate actions.

The simplest and most effective way to define control for purposes of the rule is to consider a fund which has a representative on the board to have "control" of the portfolio company, even though that representative will typically only be one of a good handful of board members who constitute the whole board.

Trickier yet is how to handle the not-uncommon situation where two or more series of preferred stock held by different VC funds vote jointly on a pooled basis to elect one or more directors. To avoid doing violence to the realities of actual VC relationships with portfolio companies, it would be preferable in such a situation to consider the various VC funds sharing in the pooled voting right each to have "control" for purposes of the rule.

Is the Reporting Requirement Necessary?

An element of the rules which may be expected to raise VC funds' legal compliance costs is the proposed new requirement that VC funds, even though they will be exempt from the formal investment adviser registration regime, nonetheless submit reports to the SEC consisting of a subset of items featured on Form ADV – in effect, a Form ADV "lite."[12]

Despite the fact that VC funds will not be required to provide a client brochure (the components of which are set forth in Form ADV Part 2), and will only be required to provide certain components of Form ADV Part 1, the practical reality is that VC funds will need to increase the amount of administrative time spent internally pulling the requisite information together and vetting it for accuracy, and will need to increase their outside legal counsel expense to verify effective compliance.

Expanded Private Fund Disclosures

In this connection, it is worth noting that the Reporting Release proposes to expand the disclosures required under Form ADV Part 1 Item 7.B and Section 7.B of Schedule D (which will be required of VC funds) to include such matters as a discussion of "characteristics of the fund that may present the fund manager with conflicts of interest with fund investors of the sort

[12] *See* Reporting Release, *supra* note 4, at 36.

that may implicate the adviser's fiduciary obligations to the fund and, in some cases, create risks for the fund investors," and information concerning various service providers to the fund.[13] Such disclosures must be carefully drafted and vetted by counsel. Furthermore, the submission of such disclosures to the SEC, although not changing the substantive legal requirements which apply to a fund manager as an investment adviser, nonetheless raises the stakes for the VC fund – there is greater likelihood of government review and investigative or enforcement action based on the submissions, and there is the possibility of personal and entity liability on statements made to the government. As a consequence, VC funds subject to the new reporting requirement may begin to implement internal policies and procedures designed to address conflicts of interest in a manner somewhat reminiscent of those put in place by registered investment advisers.[14]

Balancing the Benefit Against the Cost

Although disclosures to the government and enhanced conflict of interest policies may have some value from a regulatory perspective, the question from a rulemaking standpoint is whether the anticipated expense of meeting these new burdens is justified by the benefit. We are unaware of a history of significant issues of fraud or other abuse in the VC community which would militate in favor of imposing these burdens.[15]

Nor does it seem likely, if no new reporting requirement were to be imposed on VC funds, that a sufficient number of non-VC private funds would in bad faith attempt to claim VC status as to raise meaningful systemic risk concerns.

The SEC should therefore carefully evaluate the anticipated benefits expected from the new reporting regime applicable to VC funds against a realistic estimate of the cost of compliance, and whether the proposed reporting requirement will on the basis of those offsetting considerations be of net benefit or detriment to the economy overall.

Underestimation of Likely Cost of Compliance

Of vital importance in this regard is for the SEC to significantly alter its cost estimate procedures. A too frequent area of regulatory failure is in the production of estimates of how long it takes to comply with SEC reporting requirements. In the case at hand, the Reporting Release estimates that a VC fund adviser which advises five private funds would only require 7 hours to comply with the reporting requirement initially, and that this total would decrease

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[13] *See id.* at 40, 42, 48, 54.

[14] In connection with the proposed implementing regulations, both Commissioners Casey and Paredes indicated that they would be concerned if the proposed reporting requirement applicable to VC funds, coupled with the prospect of detailed recordkeeping requirements along with inspections by the SEC staff from the Office of Compliance Inspections and Examinations, were to cause VC funds to incur overall compliance costs which begin to approach those faced by registered investment advisers. *See* Commissioner Kathleen L. Casey and Commissioner Troy A. Paredes, Remarks at Proposing Open Meeting, *supra* note 2.

[15] In similar vein, Commissioner Paredes has noted that investors in VC funds had not historically been pressing for VC fund managers to become subject to an investment adviser registration requirement. *See* Commissioner Troy A. Paredes, Remarks at Proposing Open Meeting, *supra* note 2.

substantially in subsequent years.[16] This estimate simply bears no reasonable relationship to the amount of time which would in actual practice be required. The practical reality of educating oneself as to the new reporting requirement, studying the requirements of the form, collecting the required information and vetting it for accuracy, drafting the enhanced private fund disclosures called for the new rules, vetting the result with counsel, and going through the logistics of submitting the disclosures to the SEC, will inevitably result in many more hours being spent by internal administrative personnel than the SEC has estimated. Nor does the SEC's estimate take into account the cost of having outside counsel review the disclosures.

To begin to address the agency's consistent pattern of compliance cost underestimation, the SEC should be careful to employ in the cost estimation function attorneys with many years of experience in private practice who have lived through the realities of the disclosure compliance process.

Portfolio Company Not to Be Controlled by Public Company

An area of venture capital activity which should not be restricted by the new rules is the operation by a publicly traded company of a venture capital investment arm. There are a number of examples of such VC investment arms in Silicon Valley. Norwest (under the auspices of Wells Fargo) and Intel Capital immediately come to mind in this regard.

The proposed new rules, however, require that at the time of any VC investment, the relevant portfolio company must not be controlled by or under common control with a public company.[17] This requirement could prove problematic if the VC investment arm of a public company has previously invested in the portfolio company, under circumstances where the portfolio company might be deemed under control of the VC investment arm (e.g., if the VC investment arm enjoys a board seat), and the VC investment arm in turn might be viewed as being under the control of or under common control with its associated public company.

One potential remedy for this problem would be to create a carveout from the requirement that the portfolio company not be under control of a public company. The carveout would permit indirect control of the portfolio company in circumstances where the actual investor in the portfolio company is a bona fide venture capital investment entity, the capital commitments to which satisfy the long-term (e.g. 10 year) character described in the Exemption Release as an important identifying element of a true venture capital fund. In such a case, the VC investment arm would appear to be sufficiently insulated from the danger of having capital commitments to the VC arm investment be cancelled such that daisy-chain systemic risk would not be implicated.

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[16] *See* Reporting Release, *supra* note 4, at 132.
[17] Proposed Rule 203(l)-1(c)(4)(i).

We appreciate the opportunity to comment on these matters and are available to discuss the recommendations set forth above should the Commission or Staff desire. Ken Taymor can be reached at 510-643-6936, ktaymor@law.berkeley.edu, and Eric Finseth can be reached at 650-331-2066, eric.finseth@law.berkeley.edu.

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