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VIA E-Mail

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
rule-comments@sec.gov

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

Dear Ms. Murphy:

Thank you for the opportunity to submit comments regarding the SEC's proposed "venture capital fund" definition ("VC Fund") in connection with the rules that would implement new exemptions from the registration requirements of the Investment Advisers Act of 1940, enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Background on Our Firm

These comments are submitted on behalf of First Round Capital ("FRC"), an early-stage venture capital firm founded in late 2004. FRC has offices in West Conshohocken, PA, San Francisco, CA, and New York, NY. As is typical for an early-stage venture capital firm, our headcount is very small. We have 18 employees in total, of whom 8 are investing professionals and the balance fill administrative support roles. Our funds invest primarily in information-technology related companies (we do not invest in life sciences). FRC's core strategy is to make equity investments in pre-revenue, early-stage, technology companies. We seek to invest at an earlier stage than traditional early-stage venture capital funds and are typically the first outside investor in a company. We often invest along side "angel investor" (wealthy individuals investing their own money). Our typical initial investments range from $250,000 to $750,000. We purchase minority, non-controlling, equity interests in a portfolio company (referred to herein as "PCs"). Our typical initial ownership stake in a PC is under 20%. For certain PCs that show potential, we may commit more capital at increased valuations to maintain (or even increase) our ownership but we never own anything close to a majority interest (as of the date of this letter the largest stake we own in any PC is less than 25%.) Since our formation in late 2004 we have made over 150 initial investments. We believe that this makes us one of the most active venture funds in the country during that time period.

We are currently investing out of a fund which has approximately $135 million in capital commitments. Since inception, across all of our funds, we have raised an aggregate of approximately $325 million, and invested in over 150 companies. We pride ourselves on playing an important leadership role in our investments, and have Board seats and/or Board observation rights in many of our PCs. We believe that our PC's have created thousands of jobs. Our initial investments in PC's have been followed by $1.3 billion of follow-on investments.

We also pride ourselves on the Limited Partners ("LPs") we have attracted. Our current fund has LPs including leading universities and fund-of-funds. The majority of our LPs have been investing with us over multiple funds.

We applaud the efforts of the SEC to define what it means to be a VC Fund, and appreciate the difficulty of creating a definition that is neither too broad nor too narrow. However, we have serious concerns about some of modified in some important respects, then FRC may not be able to characterize itself as a VC Fund. If we, the earliest of early-stage institutional equity investors, are not a VC Fund then we are not sure who is.

How Do Our Own Limited Partners Define a "VC Fund"?

We believe that our LPs, most (if not all) of whom have investments in numerous asset classes, have a strong interest in defining what it means to be a "VC Fund". Our LPs have to make complicated and difficult decisions about how much of their own endowments/pension funds/pools of capital to allocate to "venture capital," as opposed to other asset classes such as private equity, buyout, hedge funds and the like. And so, once an LP has made its allocations, it is crucial to them that their outside money managers not subvert those investment allocations by shifting strategies once the funds have been committed. To that end, our Limited Partnership Agreement, like that of numerous other venture capital funds, contains a set of "investment limitations" that constrain what we may and may not invest in.

Our own LP-imposed legal restrictions, designed to ensure that we are investing like a venture capital fund, prohibit us from doing any of the following without the consent of our LPs:

- invest more than fifteen percent (15%) of the aggregate amount of the Partners' Capital Commitments to the Partnership in the securities of any one issuer;
- invest more than five percent (5%) of the aggregate amount of the Partners' Capital Commitments to the Partnership in "passive" investments in Securities purchased in the over the counter market or listed on a securities exchange;
- invest more than ten percent (10%) of the aggregate amount of the Partners' Capital Commitments to the Partnership in leverage acquisitions of privately or publicly held corporations;
- invest in any options or futures contracts, or any other Security, the value of which is based upon, or derived from, any underlying index, reference rate (e.g., interest rate), other Security, commodity or other asset;
- invest more than ten percent (10%) of the Partnership's aggregate Capital Commitments in Securities of companies having at least one class of publicly traded equity securities; or
- invest in any entity if such investment is actively opposed by such entity's board of directors or other governing body at the time of such proposed investment.

We provide this information by way of comparative example, so that the SEC can see how it is that our own LPs define what it means to be a VC Fund.

Comments on the SEC's Proposed Definition of a "VC Fund"

1. Under the SEC's proposal, at least 80% of the securities owned by the VC Fund (on a per PC basis) must have been acquired from the PC directly.

   While the vast majority of our securities are "original issuances" from the PC, there are also instances where (1) we want to own more of a company, but the company does not want to take any further dilution, so, in order to get the ownership we desire, we buy shares not just from the company but also from existing investors, or (2) the founders have a child or two to send to college (or other such pressing financial need), and we buy some shares from them directly, in order to give them some liquidity. In our experience, these types of secondary purchases, while still the exception rather than the rule, are becoming more and not less common. We think this may be in part a result of the poor economy, where individuals (angel investors and founders) may face liquidity constraints and be willing, or need to, sell shares. Furthermore, while very uncommon, there have been two instances where we wanted to acquire an equity stake in a company that was not in process of an equity raise (in each case the company has recently completed a financing with early-stage venture capital). In those instances we bought a small amount common stock (less than $500,000) from a founder and did not own any "original issuance" stock from the PC. While we feel confident that this will only take place in a small minority of our deals, it is certainly possible that with respect to any individual PC over 25% of our shares in that specific PC may have been acquired in a "secondary manner".

That is to say, we think the 20% rule is too restrictive in that the denominator consists of the securities of just one PC. **Accordingly, we propose that the 20% test be taken against committed capital (rather than per portfolio company), so that 80% of the securities *in the entire fund* are "original issuances."**

2. Under the SEC's proposal, a VC Fund's investments all must be in "qualifying portfolio companies," defined as PCs that (i) are not publicly traded, (ii) do not incur leverage in connection with our investment, (iii) do not redeem or repurchase securities in connection with our investment and (iv) are not themselves funds.

   Some of FRC's investments would fall afoul of these requirements, which is again why we believe a *de minimis* allowance is required, in order to prevent inadvertent non-compliance. Even a VC Fund in the truest sense, like FRC, will *occasionally* make investments that violate (slightly) one or more of the limitations set forth above.

   (i) <u>No leverage in connection with investments</u>: Even early stage VCs like FRC, particularly in this economy where the IPO market remains anemic, will from time to time find themselves having to support a PC through a later stage round in which a PE/later-stage type fund steps in to lead the investment round and invests in the form of both debt and equity. In other words, it is not just possible but highly probably that we are in investments in the Series Seed, Series A, Series B and Series C rounds, and then the company finds it still needs more capital to get to a sale or IPO, and brings to the table a later-stage investor, who insists on investing in the form of both debt and equity. We might participate in this round to maintain our percentage ownership, even though we personally would not invest in the form of debt. **Hence we propose that the definitions be modified to permit leverage in connection with equity investment, *so long as the firm that is seeking to be classified as a VC Fund is not the one mandating or providing the debt instrument in connection with its equity investment.***

   (ii) <u>No redemption or repurchase in connection with our investment</u>: As noted above, there are certainly instances (with increasing frequency) where the company is using proceeds from the financing to immediately repurchase some portion of the founder shares, to give them liquidity. **Here again we would propose a *de minimis* exemption, where our investments can still be considered to consist of investments in "qualifying PCs" if (1) in a particular deal, the company has used no more than 25% of the proceeds of the financing to repurchase shares from existing holders; and (2) this has happened in fewer than 20% of all of our investments (based on called capital, measured at the end of the fund).**

   (iii) <u>Under the SEC's proposal, investments must only be in operating companies, and not in funds</u>: Although again the vast majority of our over 155 investments have been in operating companies, there have been limited but significant exceptions to this rule. The occasions on which we have invested in a pass-through vehicle include (and in the future are likely to include) the following:

   - a technology incubator that creates and spins out start-ups; and
   - an offshore "holding company", which was 100% owned by us and set up for the purpose of making an investment in a PC. This two-step structure was required for tax purposes but could be deemed to conflict with the proposed rule as we technically "invested" in the wholly-owned holding company.

   Accordingly, we propose that it should be permissible to invest in an entity that is not an operating company so long as no more than 10% of the VC Fund's called capital (measured at the end of the fund) is invested in such entities.

3. Under the SEC's proposal, the VC Fund must provide "managerial assistance" with respect to each PC.

   We believe that the offer-only proposal set forth in the proposed rules is appropriate, rather than requiring that managerial assistance actually be provided or that control actually be acquired. Because each of our PCs has different needs over time based on stage, personnel and skill sets, more definitive requirements for assistance are not appropriate or necessary. For the same reason, numerical investment or ownership tests and any control requirement should be avoided – especially since venture capital funds typically do not reach the ownership thresholds necessary to exercise control in the manner often required by private equity funds.

Many smaller seed-stage funds do not take board seats in their portfolio companies or have LPs who require them to obtain management rights letters "venture capital operating company" purposes. **Accordingly, we agree that the offer-only proposal set forth in the proposed rules is appropriate.**

Conclusion

In closing, we note that, should the SEC view the various *de minimis* carve-outs that we have proposed above too cumbersome to manage, an alternative would be to simply allow a VC Fund to invest some percentage of its committed capital (we think 20% is a good number, given the small sizes of venture capital funds) in otherwise "non-conforming" investments.

On a related point, because the definition has so many elements, many of which could be read as foreclosing ordinary business practices of venture capital funds, we urge the SEC, when it promulgates the final criteria, to provide as many examples and illustrations as possible in connection with each, particularly to the extent where it can allay any concerns about what the definition is *not* meant to cover/foreclose.

Again, we appreciate the difficult task the SEC faces in setting criteria that are sufficiently inclusive to embrace the way that venture funds operate, without being so broad as to allow later stage private equity firms or hedge funds to squeeze in under the gate. However, as discussed above, we believe that the SEC definition ignores, and would prohibit, some of the business practices that are actually quite routine in and entirely consistent with early stage venture capital. We hope this letter has shed some light on those issues, and would be more than happy to answer any further questions and engage in further dialogue on this topic.

Thank you for your consideration.

Sincerely,

Chris Fralic　　Robert Hayes　　Josh Kopelman　　Howard Morgan

The First Round Capital Managing Partners