January 24, 2011

Via E-mail

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 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

Dear Ms. Murphy:

The National Association of Small Business Investment Companies is the world's oldest association of Venture Capital Funds and the Small Business Investor Alliance is forming as the newest association of small business private equity funds. We welcome the opportunity to comment on the Commission's proposed rules regarding exemptions for Venture Capital, Small Funds, and SBICs.

The Dodd-Frank Wall Street Reform and Consumer Protection Act was intended to limit systemic risk in the financial system and to protect consumers. As you are implementing the Act we would strongly encourage the SEC to consider the impact on small business investing as you write the regulations. The proposed rules add very significant costs to small business investment funds that posed and continue to pose no systemic risk.

Small business funds are private funds that provide capital directly to small businesses. These funds cover the investing spectrum from pre-revenue businesses through established small businesses. The common thread is they all invest in small businesses. Congress was clear that it wanted strong regulation of funds trading in publicly traded stocks, bonds, derivatives, or other investment vehicles commonly associated with hedge funds. However, small business funds share none of these traits.

Investment funds that serve small businesses and entrepreneurs pose no systemic risk, but are crucial to economic growth and job creation. The SBA has stated that small businesses created 65% (9.8 million) of new jobs created from 1993-2009. Given the importance of small businesses to our recovery, the

registration requirements/exemptions should not create compliance burdens incommensurate with any perceived benefit. Just last week President Obama, who signed Dodd-Frank into law, issued an executive order directing agencies to "identify and use the best, most innovative, and least burdensome tools for achieving regulatory ends" and to " take into account benefits and costs, both quantitative and qualitative." The exemptions provided in the statute indicate that Congress wanted investors using their limited resources for small business investing, not regulatory compliance.

The Dodd-Frank Act (the Act) provides for an exemption from being required to register with the SEC for certain fund advisers. The exemptions were clearly intended to protect from harm legitimate advisers whose actions create jobs. The Act exempts certain fund advisors to "Venture Capital" funds, small "Private Funds," and "Small Business Investment Companies." Without improvements to the proposal, the SEC will cause unintended negative consequences for job-creating small businesses across the nation.

We suggest the following improvements:

- Define a Venture Capital Fund in a way that is more consistent with the historical definitions of venture funding. Dating back to 1958, Congress recognized that venture funding could include more than just straight equity. The Commission should use the proposed definition, but should also allow an alternative definition. The alternative definition should define a venture fund as a fund that invests at least 75% of its capital in domestic small businesses – regardless of the instrument used.
- Clarify and make consistent with Congressional intent the Exemption for Investment Advisers Solely to Private Funds with Less than $150 million in Assets Under Management. Congress intended to avoid harming small business investing by providing a series of exemptions. The calculation for the $150 million registration threshold should exempt capital that is otherwise exempted from registration, such as Small Business Investment Company capital and Venture capital.
- Reduce costs of compliance for small business funds. The costs included in the cost benefit analysis are greatly understated. Postponing implementation of registration for funds below $500 million would allow costs of compliance to be reduced and would give the SEC an opportunity to better manage thousands of new registrants. The SEC should also consider a "Registration light" system with a lower cost of compliance for smaller funds.

A. Definition of a Venture Capital Fund

1. Qualifying Portfolio Companies

a. Private Companies

SEC:

As of year-end 2009, U.S. venture capital funds managed approximately $179.4 billion in assets. In comparison, as of year-end 2009, the U.S. publicly traded equity market had a market value of approximately $13.7 trillion, whereas global hedge funds had approximately $1.4 trillion in assets under management. As a consequence, the aggregate amount invested in venture capital funds is considerably smaller, and Congressional testimony asserted that these funds may be less connected with the public

markets and may involve less potential for systemic risk. This appears to be a key consideration by Congress that led to the enactment of the venture capital exemption. We request comment on our proposed approach.

We also considered defining a qualifying portfolio company as a small company. As in the case of defining "start-up," there is no single definition for what constitutes a "small company." We are concerned that imposing a standardized metric such as net income, the number of employees, or another single factor test could ignore the complexities of doing business in different industries or regions. As in the case of adopting a revenue-based test, there is the potential that even a low threshold for a size metric could inadvertently restrict venture capital funds from funding otherwise promising young small companies.

We request comment on any of these approaches or alternative ones that we have not discussed."

The SEC correctly recognized the Congressional view that "Venture Capital Funds" do not pose a systemic risk to the U.S. economy. It is not by accident that Congress did not narrowly define "Venture Capital Fund" in the statute. The variety of venture instruments are not easily codified, but it is this complexity that the proposal does not adequately address. Congress did not want to cut off capital to job creating small businesses. The proposed definition of "Venture Capital Fund" is so tight that it erroneously excludes varieties of small business funds that do not pose any systemic risk to the financial system, but facilitate job creation. The Commission's regulations should recognize the diversity of small business investing intended by Congress by allowing more options to receive the venture exemption.

Venture Capital Funds are funds that provide capital directly to privately held small businesses with the intent of earning a return commensurate with the significant risk taken. This investment can provide capital in many forms: equity, debt with equity features, and debt. The SEC's proposed rule adequately covers the simplest equity investment strategy, but it excludes other relevant funds. For example, throughout the Small Business Investment Act of 1958[1] (SBIA), which was critical to the creation of the domestic venture capital industry, there are numerous references to venture capital that are broader than straight equity. For example, a particular line in the SBIA states: "the term "venture capital" includes such common stock, preferred stock, or other financing with subordination or nonamortization characteristics as the Administration determines to be substantially similar to equity financing." Substantially similar does not mean same. Further, nowhere in Dodd-Frank or the Small Business Investment Act is there a preclusion of leverage to benefit small businesses. In fact, the New Markets Venture Capital program, supplies venture capital through debentures. Debentures are not usually equity. Debentures are commonly debt instruments. Some small business funds use leverage, but on such a small scale this use of debt financing in no way poses a systemic risk to the U.S. economy. The leverage being discussed in the Congressional hearings commonly used the word "big" regarding the funds using leverage. "Big" funds that use "big" leverage are not investing in small businesses. The Commission should provide the option of qualifying for the exemption by either the rule proposed or by investing at least 75% of a fund's capital in domestic small business as defined by the Small Business Investment Act.

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[1] "Public Law 85-699 (as amended): Small Business Investment Act of 1958 (72 Stat.; Date: 08/21/58). Text from: *Government Printing Office*

It is important to note that providing this option is not creating a loophole. Investments are limited to small businesses, not publicly traded firms or financial instruments. Small business investing is overwhelmingly limited to smaller funds because larger funds must deploy capital in sizes too large for small businesses to absorb. The equity definition proposed by the SEC exempts much larger funds than would be exempted by the inclusion of small business investing in definition of venture capital. Failing to provide some form of regulatory moderation for small business investing will hurt the funds that the economy needs. Either path to qualifying for the Venture Capital Exemption will not create any systemic risk.

The SEC states that because in 2009 Venture Capital Funds managed approximately $179.4 billion in assets compared with $13.7 trillion for the publicly traded equity market and $1.4 trillion for hedge funds, they are "less connected with the public markets and may involve less potential for systemic risk." There are approximately 1600 funds that are below $300 million in assets. Funds below the $150 million threshold make up the bulk of these 1600 funds. If the size of the Venture market, as defined by the SEC, is not systemically risky, why would these small business funds pose a risk by supplying capital that banks cannot? These funds were not created to "game" SEC registration, but were designed to provide capital to small businesses.

In considering the definition of "qualified portfolio company," the SEC has used the assumption that equity venture capital can go without registering with the agency due to the systemically low risk they bring due to their small number of assets under management. In the case that the systematically low risk brought about by venture investments is a leading factor in what should or shouldn't be defined as a "qualifying portfolio company," the SEC should define a qualifying portfolio company as a small company, as investments in such entities don't post a systemic risk to the US. In the Proposed Rule, the SEC states that "*We also considered defining a qualifying portfolio company as a small company. As in the case of defining "start-up," there is no single definition for what constitutes a "small company."*" The SBA's Small Business Investment Company size standards, as further explained below, are just that – a definition for what constitutes a "small company" and the SBA even defines a smaller small business by defining "smaller enterprise." The SBA maintains size standards based on industry classification; ensuring that the diversity of small businesses is taken into account. The SEC should consult with the SBA's Investment Division if it needs assistance with defining small business.

The SBA's Small Business Size Regulations[2], could and should be an option to be a "Qualifying Portfolio Company." This would ensure that no investment from a registration-exempt entity would pose systemic risk. The Regulations define a qualifying small business as one that has a net worth of less than $18 million, and has averaged $6 million or less per year in net income over the past two years. The Regulations define a smaller enterprise as one having a net worth of less than $6 million, and averaging less than $2 million in revenues for each of the past two years.

b. Equity Securities, Cash and Cash Equivalents and Short-Term U.S. Treasuries.

<u>SEC:</u>

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[2] 13 C.F.R. §121.301(c) (2003)

"We propose to define venture capital fund for purposes of the exemption as a fund that invests in equity securities of qualifying portfolio companies, cash and cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less Under our proposed definition, a fund would not qualify as a venture capital fund for purposes of the exemption if it invested in debt instruments (unless they met the definition of "equity security") of a portfolio company or otherwise lent money to a portfolio company, strategies that are not the typical form of venture capital investing. Congress received testimony that, unlike other types of private funds, venture capital funds "invest cash in return for an equity share of the company's stock." As a consequence, venture capital funds avoid using financial leverage, and leverage appears to have raised systemic risk concerns for Congress. Should our definition of venture capital fund include funds that invest in debt, or certain types of debt, issued by qualifying portfolio companies, or make certain types of loans to qualifying portfolio companies?"

Large leverage use by large funds, particularly hedge funds, pose systemic risk. The debate did not focus on small business investing because there is no evidence it could. The two types of investing should not be confused. When asked at a U.S. House Committee on Small Business hearing on "Expanding Equity Investments for Small Business" on March 29, 2009 what he thought differentiated the venture industry from "the *big* (emphasis added) buyout groups and the hedge funds," P. Sherrill Neff, Founder of Quaker BioVentures, testifying on behalf of the National Venture Capital Association, made the following statement[3]:

> "The important point is that our companies are receiving our capital in order to invest in research and development or in order to invest in job growth, and in order to invest in economic growth. These companies were not generally using any of our capital to pay off other shareholders, to buy positions of ownership from other shareholders, to repay debt and those kind of things that are shuffling the financial deck, if you will, but not being invested in core economic growth.

Small business investing is not shuffling the financial deck and it is not equity stripping. Small businesses are simply too small to make those models work. The intentions of equity venture capital funds and of other small private equity funds are largely the same: both entities are investing in companies who "invest in growth." The big difference in the use of equity versus debt instruments is that equity investments generally require the owners to sell their business for investors to get their money back. Many small business owners do not want to take their companies public, but do need capital to grow.

Trevor Loy, also a witness for NVCA, testified on September 23, 2009 before a House Committee on Small Business hearing on "The Impact of Financial Regulatory Restructuring on Small Business and Community Lenders." In examining the testimony of Mr. Loy and more importantly his subsequent interactions with Members of the Committee, it becomes clear that the primary differentiation discussed was between equity venture capital firms and very large hedge funds and very large buyout funds. The debate and differentiation was not about equity investing versus small business investing with debt instruments. Small business investing was largely overlooked or assumed in the debate. It appears that in the Proposed Rule includes similar oversight because it assumes all funds that use leverage are creating

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[3] P. Sherrill Neff, Quote from: U.S. Congress. Hearing of the House Committee on Small Business. "Expanding Equity Investments for Small Business." (Date: 3/29/09). Text from: *Government Printing Office*; Accessed 01/17/10.

systemic risk concerns. Shortly after his testimony, Chairwoman Nydia Velazquez raises a question for Mr. Loy[4]:

"Mr. Loy, in your testimony you touch on the distinction between hedge funds and venture capitalists. Given the role that hedge funds play in this debate, can you elaborate on that distinction and talk about differences about how VCs and hedge funds should be regulated?"

Clearly, the Chairwoman Velazquez focused on the use of leverage and debt instruments by large hedge funds as posing a systemic risk. Representative Velazquez did not ask for a comparison between equity venture and small business funds, as Chair of the Small Business Committee she did not need to ask if small business investing was systemically risky. Members of the Committee were not contemplating any systemic risk from small business investing. The focus was very large hedge funds and very large buyout funds because they could carry systemic risk. It is evident from the testimony that while the use of leverage by hedge funds has raised systemic risk concerns for Congress, the use of leverage by small investment funds was not even considered in the hearing, much less raising concerns for Members of the Committee.

Excluding all uses of any debt instruments from the definition of Venture Capital would be a mistake that would only inhibit the amount of capital that is available to domestic small businesses.

With regard to short term bonds and securities, the SEC should not penalize funds for the reasonable investment of idle funds so long as they remain de minimis to the operation of the fund's long term objectives.

c. Portfolio Company Leverage

SEC:

"Venture capital has been described as investing in companies that cannot borrow from the usual lending sources. Should we define a qualifying portfolio company as a company that does not incur certain specified types of borrowing or other forms of leverage? Would such a definition narrow the current range of portfolio companies in which venture capital funds typically invest?"

In determining what a permissible financing structure is for a qualifying portfolio company under the definition of venture capital, the SEC should define a qualifying portfolio company not as one that is unique in that they cannot borrow from a "usual lending source," but as one that meets the size definition of a small business, as defined by the United States Small Business Administration's regulations for the Small Business Investment Company Program[5]. Additionally, the definition of a qualifying portfolio company for the purposes of determining a venture fund should not prohibit the company from accessing borrowing tools or other forms of leverage. Congress made clear that lacking systemic risk is a key requirement for accessing the registration exemptions. Small Businesses that meeting the small business

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[4] Rep. Nydia Velazquez (NY), Quote from: U.S. Congress. Hearing of the House Committee on Small Business. "The Impact of Financial Regulatory Restructuring on Small Business and Community Lenders." (Date: 9/23/09). Text from: *Government Printing Office*; Accessed 01/18/10.

[5] 13 C.F.R. §121.301(c) (2003)

size standards under the Small Business Investment Act of 1958 (as amended) should qualify portfolio companies under the venture test.

B. Exemption for Investment Advisers Solely to Private Funds With Less Than $150 million in Assets Under Management

2. Private Fund Assets

SEC:

"In addition to assets appearing on a private fund's balance sheet, advisers would include any uncalled capital commitments, which are contractual obligations of an investor to acquire an interest in, or provide the total commitment amount over time to, a private fund, when called by the fund. Advisers to private funds that use capital commitments seek investments early in the life of the fund in anticipation of all investors fully paying in these capital commitments during the life of the fund, and fees payable to the adviser are calculated as a percentage of total capital commitments. Many of these types of private funds are managed following investment guidelines and restrictions that are determined as a percentage of overall capital commitments, rather than as a percentage of current net asset value. We request comment on whether the method for calculating the relevant assets under management should deviate from the method in the proposed amendments to Form ADV instructions by, for example, excluding proprietary assets, assets managed without compensation, or uncalled capital commitments."

The manner in which the Commission proposes determining the Act's exemption for private fund advisers with less than $150 million in assets under management lacks clarity, could unintentionally limit small business investing, and appears to run counter to Congressional intent. Congress intended to avoid harming small business investing in a number of ways by providing a series of exemptions with this being one. The $150 million dollar registration trigger should exempt capital that is otherwise exempted from registration via the Small Business Investment Company exemption and the Venture Capital Fund exemption. Congress included the term "solely" for both of these exemptions to clarify that if an adviser advised one fund that was exempted that the adviser would not have a free pass on all of the adviser's other funds. As written, the Commission is misinterpreting the term "solely" to the other extreme. Congress meant to avoid an egregious loophole, but Congress did not intend to create a near catch all either. If an adviser is advising either a venture fund or a small business investment company that is $150 million or larger, then any additional fund, no matter how small and no matter what purpose will trigger registration. This is particularly onerous for Small Business Investment Companies because they are already regulated at a much higher threshold than SEC registration provides.

When calculating the total assets under management across a number of funds for an adviser seeking an exemption under the provision that he/she advises solely "qualifying private funds" with an aggregate of less than $150 million of assets under management, the SEC currently counts SBIC leverage guaranteed by the SBA as part of a fund's assets under management. We encourage the SEC to not include the assets of a SBIC as part of the $150 million assets under management aggregate limit for advisers to be exempt under the "Private fund adviser exemption." Advisers to more than one private fund, but who are advising a total of less than $150 million assets under management of these funds should still be allowed to advise SBICs, even if the SBIC would push the adviser over the $150 million limit, as SBICs are small,

highly regulated funds that have 66% of their leverage guaranteed by the SBA. Including SBA-backed leverage creates a dilemma for those advisers who advise both small private funds and SBICs.

With regard to funds of funds and other providers of capital, the Proposed Rule would appear to run counter to the Congressional intent not to encumber small businesses and other job creators. Requiring registration for those providing the capital to exempt funds should themselves not be required to register. Encumbering small funds of funds with compliance costs for investing in small funds will just further limit the capital available to small funds. And to reiterate, small funds invest in small business.

Valuations

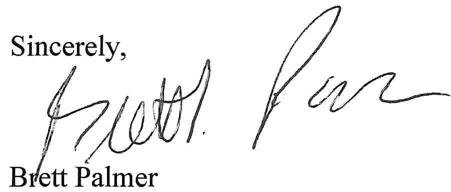
The Commission asked a series of important questions about valuations and triggering. The cost of registering is significant and offers no upside to investors in the fund or to the managers. Assessments of whether a fund has hit the $150 million threshold should not be made on a quarterly basis. Unless sought by the adviser, evaluations on whether to register should be made no more often than an annual basis. Valuations can be dynamic, particularly for small business investing. Quarterly threshold testing will lead to some false positive trigger tests.

Cost-Benefit

The Proposed Rule includes a cost and benefit analysis that is overly modest and does not recognize the burden on smaller funds. I have not found any of my member funds who are expecting their registration costs to be in line with the SEC's cost guidance. Most feedback has been more in line with some of the other comments you have received. It is worth noting that Congressional testimony supporting registration was offered by multibillion dollar funds for whom the costs are negligible. However, the cost to a small fund, like a $175 million small business fund, is much more onerous. The compliance is the same for both, but the impact is not. Even if the SEC's cost guidance were accurate, the impact on small funds is not inconsequential. If the SEC fails to exempt Small Businesses Investment Company capital from the registration trigger then advisers who have both a SBIC and a standard small business fund will have two completely different sets of reporting requirements. SBIC reporting is more intensive and SBA has closer oversight of managers, but at least there is a benefit to the public, the SBIC fund adviser, and small businesses. Doubling compliance costs for managers of private funds with SBICs will result in fewer SBICs and less capital for small business.

To minimize the financial burden on small business funds, the SEC should phase in registration. A one year delay in registering for funds with $500 million or less will greatly reduce the cost of compliance, will allow the SEC to better absorb the influx of registrants, and better understand how to adapt to small funds.

Sincerely,



Brett Palmer

President