November 29, 2018

Ms. Dalia Blass
Director
Division of Investment Management
United States Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Ms. Blass:

Thank you very much for making your staff available to meet with us on February 6, 2018 at which we discussed potential revisions to Commission rules that would further facilitate venture capital investing in the United States. We were pleased at the willingness of the staff to engage us on these important issues and are today responding to the suggestions made at the meeting that we provide you with a more detailed proposal for the staff to consider after consultation with our industry members.

Our recommendations relate solely to Rule 203(l)-1 under the Investment Advisers Act, which sets forth the definition of "venture capital fund," and thus the scope of the exemption in Section 203(l) of the Act for advisers to venture capital funds. We are enclosing a copy of Rule 203(l)-1, marked to show amendatory language the staff may consider to effect the changes we are seeking.

Background of Venture Capital Exemption

The venture capital fund exemption to the Advisers Act was enacted as part of the Dodd-Frank Act in 2010. By reducing the costs and challenges of the regulatory requirements of the Advisers Act, the exemption contributes to the ability of venture capital funds to invest in innovative growth companies. These companies are the drivers of economic growth and play a critical role in expanding opportunities for American workers. Research has shown that young companies provide an average of three million new jobs a year and have been responsible for almost all net new job creation in the U.S. in the last 40 years.[1]

The National Venture Capital Association was pleased to work with the Commission staff in 2010-2011 when Rule 203(l)-1 was proposed and adopted. Congress had created the exemption for advisers to venture capital funds that left no doubt as to its intention to provide broad regulatory relief to the industry. The details of the definition of "venture capital fund" were left to Commission rulemaking.

Congress gave the Commission little legislative record on which it could rely in developing the definition. Although the common understanding of venture capital is patient investment in start-up and growth companies, the Commission rejected such an approach because of the difficulty of determining what constitutes a start-up company. Instead, the Commission adopted a definition based largely on characteristics of venture capital funds that tend to differentiate them from hedge funds and private equity funds.[2]

Under Rule 203(l)-1, a venture capital fund is a private fund that meets the following:

(a) Represents itself as pursuing a venture capital strategy to investors and prospective investors;

(b) Holds no more than 20 percent of its aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not "qualifying investments" ("20% basket");

(c) Does not borrow, provide guarantees or otherwise incur leverage, other than limited short-term borrowing;

(d) Does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; and

(e) Is not registered under the Investment Company Act and has not elected to be treated as a business development company.

Under the rule, "qualifying investments" are limited to directly-acquired equity investments in private companies (generally, companies that at the time of the investment have not made a public offering) that do not incur leverage or borrow in connection with the venture capital fund investment and distribute the proceeds of the borrowing to the fund (*i.e.*, have not been acquired in a leveraged buy-out transaction).

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[1] John Haltiwanger, Ron S. Jarmin, and Javier Miranda, *Who Creates Jobs? Small Versus Large Versus Young*, THE REVIEW OF ECONOMICS AND STATISTICS (May 2013), *avail. at*, https://www.mitpressjournals.org/doi/pdf/10.1162/REST_a_00288.

[2] *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers*, Investment Advisers Act Rel. No. 3222 (June 22, 2011) ("Release 3222") ([T]he proposed definition of venture capital fund was designed to distinguish venture capital funds from other types of private funds, such as hedge funds and private equity funds . . .").

While the conditions accurately reflected the characteristics of most venture capital funds in 2011, none of the elements of Rule 203(l)-1 are inherent in a venture capital fund. For example, a fund that holds an interest in an early-stage high-tech company acquired from one of the founders is no less a venture capital fund than a fund that acquired its interest directly from the company. Nevertheless, the rule treats the two funds differently--permitting investment in the former only to the extent there is room in the fund's 20% basket.

Our point is not that the rule is irrational or that it does not work as intended, but rather that the terms of the definition should not be viewed as immutable and bear re-examination more than seven years later in light of experience and developments. To the extent that the rule unnecessarily inhibits venture capital investing and/or public offerings by venture capital portfolio companies, we urge that consideration be given to revising its terms.

Discussion of Recommended Changes

The rule as it operates today excludes several types of investments that venture capital funds should be able to make without jeopardizing their adviser's exemption, investments that are consistent with the nature of venture capital investing and important to the economics of venture capital formation. Moreover, these exclusions create dis-incentives for venture portfolio companies to make a public offering, which were not recognized or identified by the Commission when it adopted the rule. Finally, the rule excludes a whole class of new investments in start-up companies that barely existed in 2011. We make six recommendations that would address these matters.

1. *Emerging Growth Companies*

We recommend the Commission amend Rule 203(l)-1 to treat an "emerging growth company" as a qualifying portfolio company under that rule. As discussed below, the use of the term would expand the ability of venture capital funds to support the growth of U.S. companies without changing the nature of the funds whose advisers Congress intended to be exempt from full registration under the Advisers Act.

One year after the adoption of Rule 203(l)-1, Congress enacted the Jumpstart Our Business Startups (JOBS) Act, which reduced regulatory obligations and made other changes in the federal securities laws to encourage the development of growth companies by making it easier for them to raise capital in initial public offerings (IPOs). Congress concluded that these companies are critical to the economic growth of the country. They are companies similar to those in which venture capital funds invest, but are significantly constrained by Rule 203(l)-1, as discussed in more detail below. Both the venture capital fund adviser exemption and the statutory exemptions for emerging growth companies arise from the same goal--to encourage capital formation for this subset of issuers consistent with the protection of investors.

The concept of an "emerging growth company" and the understanding of the importance of such companies to the U.S. economy grew out of a 2011 report to the Treasury Department by the IPO Task Force, entitled "Rebuilding the IPO On-Ramp." The report recommended creating a new category of issuer that would be permitted a "regulatory on-ramp" that would temporarily reduce regulatory burdens to mitigate costs that discourage companies from seeking capital in the public markets. Therefore, the report recommended that the ramp last a maximum of five years after an issuer makes its IPO.

a. The Current Rule Discourages Public Offerings, Reduces Market Liquidity, and Unnecessarily Restricts the Supply of Venture Capital Investments

We are concerned that Rule 203(l)-1 discourages venture portfolio companies from making an IPO. This is one of the unintended effects of the rule's requirement that at the time of investment by the venture capital fund a "qualified portfolio company" not be a "reporting company," *i.e*., not have made a public reporting of its securities. Once the portfolio company makes its first public offering, it is all but cut off from further investment from venture capital funds, even though the company may be significantly smaller than other private companies, including so-called "unicorns," which choose to remain private while achieving revenues historically associated with public companies.

Although the rule permits a venture capital fund to hold up to 20 percent of its assets in publicly-traded securities, it operates to place a meaningful penalty on a company considering a public offering, thus offsetting some of the intended gains of the JOBS Act. It discourages venture capital funds from continuing to invest in companies that are on the "regulatory on-ramp" and thus otherwise benefit from national policy encouraging these engines of economic growth. While Congress was "pressing the gas pedal" to encourage IPOs in the JOBS Act, the venture capital rule "tapped the brakes" by discouraging, albeit unintentionally, the same offerings.

Rule 203(l)-1 also operates to reduce market liquidity of securities issued by venture capital portfolio companies that do make IPOs. By limiting the amount of their assets that a venture capital fund may buy (and thus sell) in secondary markets, the rule reduces the companies' market float and the interest in these companies of market professionals, as well as large classes of investors for whom liquidity is an important investment consideration. In the case of a venture capital portfolio company that never makes an IPO, Rule 203(l)-1 makes it more difficult for early investors to sell their securities to venture capital funds by limiting "qualifying investments" to those purchased directly from the company. As a result, the firm's founders may find it more difficult to find buyers and be forced to sell at a lower price when they seek to sell shares privately because venture capital funds are limited in the amount of such securities they may purchase from sellers other than the issuer itself.

b. The Commission Should Look to a Statutory-Based Solution that Addresses the Unintended Consequences of the Current Rule

We urge the Commission to address the adverse consequences of Rule 203(l)-1 by also treating "emerging growth companies" as qualifying portfolio companies. This could be accomplished by revising the rule to reference the term defined in Section 2(a)(19) of the

Securities Act of 1933, thus permitting all of a venture capital fund's assets to be invested in "emerging growth companies." [3]

Under Section 2(a)(19) an "emerging growth company" is a company that had total gross annual revenues of less than $1.07 billion during its most recently completed fiscal year and, as of December 8, 2011, had not made a public offering of equity securities. A company continues to be an emerging growth company for the first five fiscal years after it makes a public offering, unless one of the following occurs: (i) its total annual gross revenues are $1.07 billion or more, (ii) it has issued more than $1.07 billion in non-convertible debt in the previous three years, or (iii) it becomes a "large accelerated filer," as defined in Rule 12b-2 under the Securities Exchange Act of 1934.

This is the definition Congress chose to employ to identify the small and emerging companies in the 2012 JOBS Act. We suspect that this definition would have been used by the Commission in developing Rule 203(l)-1 except that the legislation was later enacted. Indeed, in the adopting release, the Commission appeared to lament the absence of any legislative guidance when considering the comments it had received and the nature of the 20% basket it adopted. Shortly after the enactment of the JOBS Act, the Division of Investment Management issued a "FAQ" employing the new definition (appropriately in our view) to treat business development companies ("BDCs") as emerging growth companies, notwithstanding Congress' failure to do so.[4] As you know, BDCs are the publicly-offered equivalent of venture capital funds and thus the policy issues are highly analogous.

Permitting venture capital funds to invest freely in emerging growth companies would eliminate the rule's inherent "IPO penalty" by permitting venture capital funds to make investments in these companies after an IPO, participate in the secondary market for these companies' shares for a period of time, and purchase shares directly from the company's founders helping them earn the rewards for risk-taking even if the company never has a public offering. Moreover, increased trading in shares of these companies in the secondary market would improve liquidity and price discovery in these markets.

By permitting venture capital funds greater latitude to invest in equity investments of venture capital portfolio companies in the secondary markets, the Commission would significantly expand the supply of securities available to venture capital funds without significantly changing their character. As we noted above, a venture capital fund that buys the same security in a secondary market transaction is not thereby any less of a venture capital fund than one that purchases the security directly from the issuer. Although some emerging growth companies may be larger and more mature companies than those companies in which venture capital funds today invest, the current rule imposes *no size or maturity limitations* on qualified

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[3] On August 3, 2018, the House Committee on Financial Services reported a bill, H.R. 6177 that, if enacted, would require the Commission to amend Rule 203(l)-1 to make similar (although not identical) changes in order to expand the range of qualifying portfolio companies. *See* https://www.congress.gov/bill/115th-congress/house-bill/6177/text?q=%7B%22search%22%3A%5B%22H.R.+6177%22%5D%7D&r=1. Given the brief amount of time left before Congress adjourns, we do not expect this Congress to act on the bill.

[4] *Jumpstart Our Business Startups Act Frequently Asked Questions*, Question 21, *avail.at*, https://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm#fn1.

portfolio companies that have not made a public offering. As long as growth companies are discouraged from making public offerings, the Commission should expect the size and maturity of companies held in venture capital fund portfolios to grow as so-called "unicorn" companies become more numerous.

In this regard, we urge that the Commission retain the current provision treating directly-purchased investments in non-reporting companies as investments in qualifying portfolio companies. Keeping this provision would preserve the ability of venture capital funds to invest in the "unicorns" that have more than $1 billion in annual gross revenues and thus would not be emerging growth companies. The elimination of this provision could disrupt some of our members' fund strategies.

Finally, we emphasize that because Rule 203(l)-1 is constructed as a multi-factor test, funds will still have to meet other parts of the definition, including limits on leverage and prohibitions on redemptions, to qualify as a venture capital fund. If the Commission pursues our recommendations, it will not have strayed from the purpose and policies of Section 203(l) of the Advisers Act.

2. *Investments in Other Venture Capital Funds*

We also recommend the Commission permit investments in other venture capital funds to be treated as qualifying investments. Funds of funds investments are important to venture capital investing in several ways:

- Established venture funds provide seed capital for newer funds and fund managers in order to support new investing strategies and talent.

- Venture funds may make investments in other venture capital funds to more efficiently obtain exposure to particular types of venture capital. A manager with regional venture capital experience (*e.g*., Silicon Valley) may deploy some fund capital to invest in, for example, a Midwestern fund manager. This is not unlike mutual funds that will obtain exposure to a particular market by investing in another fund.[5]

- In some cases a venture capital fund of funds structure is deployed by regional economic development authorities in cities like Houston to attract risk capital for local start-up companies that contributed to regional development.[6]

- Some venture capital funds invest solely in other venture capital funds in response to investor interests in diversifying risks by investing in multiple managers with different strategies.

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[5] *See* Rule 12d1-1 (exemption permitting registered funds to invest in shares of money market funds).

[6] "Houston Launches its First Venture Capital Fund of Funds," GLOBE NEWS WIRE (Oct. 24, 2017), *avail. at*, https://globenewswire.com/news-release/2017/10/24/1152597/0/en/Houston-Launches-its-First-Venture-Capital-Fund-of-Funds.html.

So long as the strategy ultimately employed is consistent with venture capital investing, investing in other venture capital funds is entirely consistent with the purpose of Congress in providing for a venture capital exemption. The SEC has taken similar position on many occasions, permitting a fund to "look through" the form of an investment to its economic characteristics.[7]

Rule 203(l)-1 currently operates to restrict the amount of other venture capital funds in which a venture capital fund may invest by defining "qualifying portfolio company" to exclude any other private fund that relies on section 3(c)(7) for exclusion from the Investment Company Act. As a result, venture capital funds must limit their investments to the amount available in their 20% basket.[8] We recommend amending the rule to treat as qualifying investments venture capital funds that themselves meet the requirements of 203(l)-1, subject to limits discussed below.

The Commission considered permitting venture capital fund-of-funds in response to comments on its proposal (including one from the NVCA) but rejected such an approach out of apparent concern that a venture capital fund could "circumvent the intended scope of the rule by investing in other pooled investment vehicles that are not themselves subject to the definitional criteria under our rule." We recommend that this concern be addressed by simply limiting qualifying fund-of-funds investments to those venture capital funds that meet the rule's definition.

In the SEC's 2011 release adopting the rule, the Commission also expressed concern that a fund-of-fund structure could be used to circumvent the restrictions on leverage and investments in non-qualifying investments. We recommend addressing this concern by requiring the acquiring venture capital fund to aggregate leverage and non-qualifying investments at both levels at the time of investment.[9] As a result, an adviser to a venture capital fund investing in another venture capital fund would be required to test the allowances in Rule 203(l)-1 against the

[7] *See*, *e.g.*, Rule 2a-7(d)(3)(E) (diversification of holdings of other money market funds); *Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows*, IM Guidance Update (June 2014) (adviser may treat assets of special purpose vehicle as assets of a private fund for purpose of complying with the audit approach of complying with the custody rule, Rule 206(4)-2) under the Advisers Act; Rule 5b-3 (investment company may "look through" a repurchase agreement to the collateral for various purposes under the Investment Company Act). Perhaps the best analogy is to the operation of Rule 35d-1, the "names rule," under the Investment Company Act, which requires that a registered fund with a name that suggests that the fund will focus its investments in a particular investment invest at least 80% of its assets in such investments. In its adopting release, the Commission explained that in appropriate circumstances funds could treat a "synthetic security" in the 80% basked if it has "economic characteristics similar to the securities held in that basket." *Investment Company Names*, Investment Company Act. Rel. No. 24828 (Jan. 17, 2001) at n. 13. We understand that sponsors of registered funds rely on that footnote to include investments in other funds as "synthetic securities" qualifying for the 80% basket.

[8] When it adopted rule 203(l)-1, the Commission stated that an adviser may treat a fund as a venture capital fund if it holds qualified investments through a wholly-owned holding company. Investment Advisers Act Rel. No. 3222 at 51-52. In this regard, the NVCA seeks relief from the "wholly owned" limitation.

[9] Testing compliance with an investment restriction at the time of investment prevents non-compliance as a result of market action. The Commission has taken a similar approach in other rules. *See* Rule 2a-7(d)(3) (portfolio diversification of money market funds) and Rule 22(e)-4(b)(iv) (restrictions on illiquid securities of open-end management companies).

cumulative amount of leverage and non-qualifying investments at *both* levels to ensure that these activities remain at levels consistent with the restrictions of the rule in aggregate.

3. *Subscription Credit Facilities*

We urge that the Commission revise Rule 203(l)-1 to permit venture capital funds to participate in subscription credit facilities without being subject to the limitations on leverage currently in the rule. As discussed in more detail below, the arrangements are not entered into for the purpose of leverage and do not result in any increase in systemic risk, but play an increasingly important role in the effective management of venture capital funds.

Venture capital funds typically finance their operations by obtaining callable capital commitments from investors. Rather than taking receipt of all capital at the outset of the fund, the fund will issue notices to investors that they must contribute capital (referred to as a "capital call") as investment opportunities arise that require investors to provide funds, typically within ten days. Investment opportunities may be lost if capital cannot be delivered within that period. But there are a number of reasons why capital calls can be delayed, including challenges limited partners may face in making the capital available in a short period of time.

To avoid missing investment opportunities or offending investors, venture capital funds will enter into one or more subscription credit facilities, which typically take the form of senior secured revolving credit arrangements with financial institutions, such as banks. Borrowings are usually secured by the uncalled capital commitments and used to provide liquidity for the fund before capital is received. Whereas a fund making a call may have to wait as many as ten days or more for cash, the liquidity facility may be accessed almost immediately.

Rule 203(l)-1 currently restricts a venture capital fund's ability to borrow up to 15 percent of the fund's aggregate capital contributions and uncalled committed capital commitments for a non-renewable term of no more than 120 days. Most of our members do not borrow for purposes of leveraging their portfolio, yet we receive reports that this restriction is now hampering their ability to draw on their subscription credit facilities for normal business activities. While the use of such facilities may have not been constrained by the rule when it was adopted in 2011, fund financing has grown significantly since that time.

We do not favor increasing the ability of advisers to venture capital funds to leverage their funds simply to allow for greater use of subscription credit facilities. We support today, as we did in 2011, the rule's leverage limitations. Instead of increasing the amount of allowable leverage, we ask that the Commission add to the rule a separate exemption for subscription credit facilities that would allow an unlimited amount of borrowing for the limited purpose of providing fund liquidity pending receipt of capital contributions and which is secured by a pledge of the contributions. The term of the commitment of the lender could be up to but no more than one year. The amount of the borrowing would be (implicitly) restricted by the amount of uncalled commitments available to secure the loans.

While subscription lending arrangements technically involve a borrowing by the fund, we believe that such arrangements are functionally the equivalent of borrowings by the fund's limited partners who would otherwise be called upon to provide capital. They can thus be viewed as advances of payments the fund's limited partners are contractually obligated to make. From the perspective of the fund, the borrowing is economically similar to the sale of an account receivable. The borrowings are secured by the borrower's unfunded commitments; the lender assumes the right to enforce those obligations against the investors and may require investors to make payment of their commitments, when called, directly to the lender's account. Indeed, the willingness of lenders to lend money and the rate at which they will lend depends not on the credit of the venture capital fund, but on the creditworthiness of fund investors.

The terms of the financing under these subscription lending agreements tends to be short inasmuch as they are used for bridging capital calls. The facilities themselves, however, may be available for longer periods and drawn upon on multiple occasions as investment circumstances warrant. Therefore, we recommend that the commitments made by the facilities be available for a renewable period of up to 365 days.

We believe that, properly limited as we have suggested, the availability of these lending facilities will not inappropriately change the essential nature of venture capital fund activity. Nor would they lead venture capital funds to take on systemically significant leverage. Subscription lending arrangements are benign financial arrangements that merely permit managers to smooth capital calls while allowing them to deploy capital at the speed of the industry.

4. *Investments in ICOs, Tokens and Other Digital Assets*

We recommend that the Commission revise Rule 203(l)-1 to permit venture capital funds to invest more broadly in initial coin offerings (ICOs), tokens and other forms of digital assets. Such a change would permit venture capital funds to more significantly participate in, and therefore act as a positive influence on, one of the potentially most dynamic and innovative developments in the capital markets in recent years. The changes we seek would also give investors access to these markets through a fund managed by venture capital professionals who are in a much stronger position to safeguard their interests. Whatever one's views are on the potential of these types of offerings, it seems apparent that the most logical source of financing for this emerging field is venture capital.

a. The Need for Limited Regulatory Relief

A number of our members have taken relatively small positions in various digital investments, including Simple Agreement for Future Tokens (SAFT) contracts and tokens. Many of the legitimate companies issuing these instruments are new companies in the "sweet spot" of many of our members whose expertise is in evaluating the prospects of early stage start-up companies and emerging technological fields. The risks of investment in these companies is typically substantial, but not significantly different than the risk of investments in other start-up companies that may have little revenue and few assets and whose business models or technologies are unproven.

Nonetheless, under Rule 203(l)-1 venture capital funds are substantially limited in the amount they can make in digital investments by the capacity of their 20% basket, which may be committed for other purposes. For the same reason, a venture capital fund focused on digital investments is simply not possible. This is *only* because many of the digital investments may not be "equity securities" as that term is defined in Rule 203(l)-1 and consequently such investments are limited to the remaining capacity of a venture capital fund's 20% basket.

Under Rule 203(l)-1, a fund's "qualifying investments" are limited, among other things, to investments in equity securities. As SEC Chairman Clayton has publicly noted, most ICOs are securities offerings that should be registered with the Commission or sold in reliance upon an exemption. However, most of the offerings may not constitute equity securities offerings according to the lawyers with whom we have discussed this question. Given the small size of many digital offerings, their heterogeneity, and the complexity of the issues, it is simply not economically feasible for our members to engage legal counsel to determine in a timely fashion the ability of a venture capital fund to treat them as qualifying investments--the costs of the legal advice may exceed anticipated profits from the investment.

It strikes us that, at least in the case of digital investments, the divide drawn by the Commission between equity and debt obligations may no longer be useful to distinguish venture capital funds from private equity and other funds for which the rule was not intended to be available. Although the Commission correctly concluded in 201l that investment in equity securities (as opposed to debt securities) was at that time one of the characterizing features of venture capital portfolio companies, that historical conclusion today threatens to freeze venture capital funds out of what may (or what may not) become an important part of the new wave of venture capital portfolio companies that choose to raise funds through digital offerings that may or may not be equity securities.

b. The Market Benefits of Venture Capital Participation in the Market for Digital Investments

Besides fostering innovation, permitting venture capital funds to invest in digital investments would further important public policy goals the Commission is today pursuing primarily through its enforcement actions. As we have discussed above, the venture capital industry is uniquely well-positioned to evaluate new and untested business plans and to distinguish market opportunities from pipe dreams. Our members also have the business savvy and commercial skill to protect their investors from potential frauds, Ponzi schemes, and hucksters who exploit investors through ICOs and other digital offerings and who figure largely in some of the enforcement actions brought by the Commission and the Commodities Futures Trading Commission.

We are confident that, if given sufficient economic interest to participate fully in this market, venture capital funds together with other professional technology investors, will over time develop industry standards, best practices and due diligence protocols that will make it more difficult for fraudsters to prey on the uninformed. It is our members' hope that they can take an active role in building the market for digital investors.

Our members have the same interest as the Commission in driving the unscrupulous fraudsters from these markets. Some have been and undoubtedly others will in the future be burned by fraudsters and simply bad business models. Nevertheless, exercising only their business judgment and fiduciary obligations to their investors, members of the NVCA believe that they can be effective partners with the Commission to help address current problems in this market if they can participate without restriction.

c. Venture Capital Funds are Different from Registered Investment Companies

We have read and considered the staff's letter of January 18, 2018 to the Investment Company Institute and the Asset Management Group of SIFMA asserting that "cryptocurrency and related products" are too risky and raise too many regulatory issues under the Investment Company Act for retail products such as registered investment companies to invest substantially in at this time. We have no position on this question but wish to emphasize to you that consideration should be quite different regarding venture capital funds, which are not subject to the Investment Company Act, do not offer investors liquidity, which cannot be purchased by "retail investors," and whose business models are predicated on high-risk, long-term investment in emerging technologies.

Almost all investors in venture capital funds are "accredited investors" who have purchased their interests in private offerings from issuers relying on Regulation D under the Securities Act of 1933. And most of our members rely on exclusion from the Investment Company Act provided by Section 3(c)(7) and offer their shares only to "qualified purchasers," which are presumed to have a high degree of financial sophistication and are in a position to appreciate the risks associated with investment pools that do not have the protections afforded by the Investment Company Act.[10] These funds are permitted to assume a very high degree of risk and may *today* freely invest an unlimited portion of their assets in digital investments. There are no limits on the types of investment they may make. The question we raise is whether a small subset of such funds may acquire the same digital investments and still meet the requirements to be a "venture capital fund" under the Advisers Act.

d. The Scope of the Appropriate Relief

Drafting rule text that would provide the appropriate relief will be challenging because the digital offering market is in its formative stages and, as the staff knows, many legal questions are still unresolved. Our suggested language would permit a venture capital fund to treat as a qualifying investment a token issued by a qualifying portfolio company, including an emerging growth company. Importantly. the scope of companies issuing tokens in which venture capital portfolio companies could freely invest would be cabined by the requirement that the company be an emerging growth company (or a company that is not a reporting company) at the time the venture capital fund makes the investment.

Our suggested language would not attempt to distinguish between tokens that are securities or commodity futures contracts from so-called utility tokens that may be neither. The law is so unsettled in this area as to make such a distinction impracticable in the operation of a venture capital fund. Unlike the application of other provisions of the federal securities laws (such as the anti-fraud provisions), whether a token is characterized on one or the other side of the line (or whether, as recently contemplated by Division of Corporation Finance Director

[10] S. Rep. No. 293, 104th Cong., 2d Sess. at 3 (1996).

Hinman,[11] a digital investment that was originally offered in a securities offering is later sold in a manner that does not constitute the offering of a security) would seem to have lesser consequences to investors.[12] Thus we submit that it is an area of the law in which the Commission can provide some helpful certainty without undue concern about the consequences. The availability of a more expansive venture capital exemption simply permits a venture capital adviser to file Form ADV with the Commission as an exempt reporting adviser (ERA) rather than a registered adviser—all the anti-fraud provisions under the Advisers Act would remain in place. In this regard, we note that the application of Advisers Act's anti-fraud provisions do not turn on whether the digital investment is a security.[13]

5. *Holdings in Virtual Currencies*

We recommend that the Commission more clearly permit venture capital funds to treat virtual currencies (*i.e.*, cryptocurrencies) as "cash equivalents," in which the rule permits a venture capital fund to invest without limit. A number of our members invest in virtual currencies but are currently limiting their investment to amounts available in their 20 percent basket. We believe that it would be helpful to our members and consistent with the purposes of the exemption to permit venture capital funds to invest in virtual currencies as if they were traditional forms of cash or cash equivalents.

In determining whether a private fund has at least 80 percent of its assets invested in "qualifying investments," Rule 203(l)-1 permits a fund to exclude certain "short-term holdings," including cash and cash equivalents. Cash and cash equivalents are defined by reference to Rule 2a-51 under the Investment Company Act, which defines them to include, among other things, bank instruments, Treasury securities, and foreign currencies held for investment purposes. While virtual currencies are not listed (they were unknown in 1997 when Rule 2a-51was adopted), the list includes instruments issued by institutions that are public (Treasury notes), private (bank notes) and foreign and instruments acquired regardless of the purpose and the nature or amount of the risks assumed. In the case of foreign currencies (which are perhaps the closest analogy to virtual currencies), the rule permits a fund to assume a substantial amount of investment risk. Indeed, Rule 2a-51 specifically permits *without limit* foreign currencies and other cash equivalents held for investment purposes.

In light of the characteristics of the instruments that are specifically permitted, we believe that Rule 2a-51 (and thus Rule 203(l)-1) may be read to include as cash equivalents virtual

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[11] *See* https://www.sec.gov/news/speech/speech-hinman-061418.

[12] We are sympathetic to Commissioner Jackson's recently-reported remark that it would be "silly" for the Commission to write rules for ICOs when the investments are evolving so quickly. *See* https://www.forbes.com/sites/tedknutson/2018/06/11/silly-for-sec-to-write-ico-rules-when-sector-changes-quickly-asserts-commissioner-jackson/#78893d38136b. However, we read his remark to be on the wisdom of attempting to write rules that distinguish ICOs that are securities under the federal securities laws from those are not. We propose something much less ambitious.

[13] *Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services,* Investment Advisers Act Rel. No. 1092 (Oct. 8, 1987) (Section 206(1) and 206(2) "do not refer to dealings in securities but are stated in terms of the effect or potential effect of prohibited conduct on the client.").

currencies, such as Bitcoin and Ether. Indeed, the SEC's Division of Enforcement, in the most significant pronouncement of the Commission today on digital-based securities offerings, described Bitcoin and Ether as a "virtual currency."[14] Moreover, the CFTC has approved trading of futures contracts on Bitcoin, which today successfully trade on the same markets that trade futures on Treasuries and foreign currencies (held as cash equivalents by venture capital funds).

Out of an abundance of caution, however, our members report that they do not treat holdings of virtual currencies as cash.[15] An amendment to the rule (or staff guidance) clarifying this interpretive question would be very helpful and would facilitate venture capital funds holding what could be characterized as another foreign currency. We propose to define a virtual currency as a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value, although such currency may not be legal tender.[16]

6. *Certain Venture Capital Funds Exempt from the Investment Company Act*

Recently, Congress passed the Economic Growth, Regulatory Relief, and Consumer Protection Act,[17] which, among other things, amended the Investment Company Act to create an exemption for a certain type of venture capital fund that would otherwise be required to register (and be regulated as) investment companies. Section 504 of the Act permits a venture capital fund that has as many as 250 investors to qualify for the exemption provided by Section 3(c)(1) of the Act if it has less than $10 million in aggregate capital contributions and uncalled committed capital (with such dollar amount to be adjusted for inflation once every five years).

Most significantly, for purposes of this letter, Section 504 defines the term "venture capital fund" by specific reference to Rule 203(l)-1 under the Advisers Act. As a result, any expansion of the exemption provided by the rule will expand the exemption to the Investment Company Act.

Venture capital funds sponsored by our members currently rely on Section 3(c)(7) or 3(c)(1) of the Investment Company Act as provided before the recent amendment. The $10 million limit on aggregate called and uncalled capital is too low for most of these funds to qualify, and our members hope that those venture capital funds that do qualify will grow to more than $10 million. The legislation itself is unclear as to what will be the consequences if, as a result of market action, the assets of a venture capital fund grow beyond the $10 million limit.

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[14] *Report of the Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Exchange Act Rel. No. 81207 (July 25, 2017).

[15] This is, in part, because there have been no official accounting pronouncements from FASB or other accounting standards setters as to whether a cryptocurrency would be considered a "cash equivalent" for purposes of financial statements. In this regard, however, we note that the definition of cash and cash equivalents rule 203(l)-1 is not limited to instruments, including U.S. Treasury securities, which accountants would regard as cash items.

[16] Our suggested rule text language draws on the definition proposed in the FATF Report, Virtual Currencies, Key Definitions and Potential AML/CFT Risks, FINANCIAL ACTION TASK FORCE (June 2014), http://www.fatf-gafi.org/publications/methodsandtrends/documents/virtual-currency-definitions-aml-cft-risk.html.

[17] Public Law No. 115-174.

We are concerned that the staff might consider it inappropriate for the Commission to consider amendments to Rule 203(l)-1 that would consequently expand the new venture capital exemption under the Investment Company Act so soon after it was enacted. That is, of course, not our goal. If the staff has such a concern, we would support the addition of a provision in the rule that would treat emerging growth companies as qualifying investments only for private funds relying on an exemption provided by Section 3(c)(1) that have no more than 100 beneficial owners.

* * * * *

We again thank you for making your colleagues available to meet with us and look forward to working with you. If you have any questions or concerns you have about our recommendations, please contact Justin Field, Senior Vice President of Government Affairs at 202.864.5929.

Sincerely,

Bobby Franklin

Bobby Franklin
President and CEO

cc:

Chairman Jay Clayton
Commissioner Kara M. Stein
Commissioner Robert J. Jackson Jr.
Commissioner Hester M. Peirce
Commissioner Elad L. Roisman

Paul G. Cellupica, Deputy Director—Chief Counsel
Sarah G. ten Siethoff, Associate Director
Sara Cortes, Assistant Director
Division of Investment Management

Attachment