January 21, 2011

As you know, President Barack Obama signed *The Dodd-Frank Wall Street Reform and Consumer Protection Act* ("Dodd-Frank") into law on July 21, 2010. Public Law No. 111-203. *Dodd-Frank* substantially revises many federal financial services and securities laws. Effective July 21, 2011, *Dodd-Frank* eliminates the existing "private adviser" exemption set forth in *Section 203(b)(3) of the Investment Adviser Act of 1940*. *Section 203(b)(3)* exempts from federal registration any investment adviser who has fewer than fifteen clients and who neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company. Advisers to alternative investment vehicles such as hedge funds, private-equity funds, and venture capital funds frequently rely on the *Section 203(b)(3)* exemption from registration.

In California, exempt investment advisers under the *Section 203(b)(3)* have had a corrollary exemption under California investment adviser licensing requirements, if they meet the requirements of *Rule 260.204.9 of Title 10 of the California Code of Regulations*, and (1) have assets under management of not less than $25,000,000, or (2) exclusively advise "venture capital companies, as that term is defined in the rule. As a result of Dodd-Frank, on July 21, 2011, *Rule 260.204.9* will no longer provide an exemption from California licensing requirements.

In anticipation of these changes, the California Corporations Commissioner is considering amending *Rule 260.204.9*. The Commissioner is studying the issue of how best to regulate advisers to alternative investment vehicles, while balancing the regulatory burden on such advisers, with any corresponding investor protections issues. The Commissioner anticipates that any proposed rules exempting such advisers will be effective on, or before July 21, 2011.

Importantly, in order to promote consistency with federal law, the Commissioner awaits the final promulgation of SEC rules, prior to finalizing any regulations. In fact, the Commissioner has commented on the SEC's proposed definition of "venture capital fund." (See comment letter below).

Inquiries concerning the expected rulemaking may be directed to Ivan V. Griswold, Corporations Counsel, Securities Regulation Division, at (415) 972-8937. Written comments or proposals may be submitted to Ivan V. Griswold, Department of Corporations, Securities Regulation Division, 71 Stevenson Street, Suite 2100, San Francisco, CA 94105.

DEPARTMENT OF CORPORATIONS
Business Services and Consumer and Investor Protection

Preston DuFauchard
California Corporations Commissioner
San Francisco, California

January 21, 2011

Via Electronic Mail

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Rule-comments@sec.gov

Re: Venture Capital Fund Definition, Release No. IA – 3111; File No. S7-37-10

Dear Ms. Murphy:

As the Commissioner for the California Department of Corporations (Department), I submit the following comment to the draft definition of Venture Capital Fund (VC Fund), currently proposed by the Securities and Exchange Commission (SEC).[1] By this comment we urge the SEC to expand the scope of permissible use of VC Funds in a manner that allows VC Fund advisers to determine the optimal financing mechanism for their portfolio companies, without risking the loss of VC Fund advisers' exemption from registration.

The importance of VC Fund investments to California cannot be overstated. One recent source reports that over forty-five percent (45%) of VC Fund deals in the third quarter of 2010 were located in California. (Silicon Valley – 36.1%; LA/Orange counties – 4.83%; San Diego – 4.8%; and Sacramento/Northern California – .11%) See PwC/NVCA Money Tree Report based on data from Thomson Reuters, 2010 Q3, available at www.pwcmoneytree.com. New ventures whether in fields of computer technology, biotechnology, clean technology, social media,

[1] Although in its release, the SEC refers to the California Corporations Commission, no such entity exists. Instead, the Commissioner heads the Department, and the term Commissioner is similar to that of State Insurance Commissioner. In this letter, I shall use the collective "we" to refer to the Office of Commissioner and the Department.

internet search, mobile technology, and others, all trace their formative stages to California VC Fund investments.

The prominence of VC Fund investments in California, therefore, provided the basis for the Department's attempt some years ago to do precisely what Congress has tasked the SEC to do now; to define "venture capital fund," and to exclude advisers to these funds from regulatory oversight. In devising the Department's definition for VC Fund, we strived to accomplish two major objectives: (1) to distinguish a trading or hedge fund model from a true venture-based investment vehicle; and (2) to provide the maximum flexibility for VC Fund advisers and managers to determine the optimal financing arrangements needed to promote growth of their portfolio companies, while at the same time protecting the VC Fund investments. We believe the definition at Title 10, California Code of Regulations, section 260.204.9 (b)(3), meets both these objectives. Our definition in no way has hindered the growth and successful management of VC Fund investments.

Unfortunately, we understand the SEC cannot adopt verbatim the California definition of VC Fund. Congressional directives require the SEC to exclude private equity funds, or any fund that pivots its investment strategy on the use of debt or leverage, from the definition of VC Fund. And, while regulators might have an interesting discussion on whether private equity funds contributed to the recent financial crisis, in light of the Congressional directives such a dialogue would be academic.

We are concerned, however, that the definition of VC Fund proposed by the SEC may inhibit the continued growth of VC Funds. Specifically, we are concerned that the SEC's proposed definition of VC Fund unduly restricts the scope of financing tools available for VC Fund advisers. The worst possible result for the California economy, even the national economy, would be to inhibit VC Fund raising or VC Fund investments due to the homogenization and narrowing of fund activities. VC Fund investments, to date, have been robust precisely because there have been relatively few constraints on the manner in which the VC Funds have operated. In California, we define "VC Fund" to provide just such flexibility in the management of VC Fund investments.

To obviate the risk of a weakened VC Fund investment appetite, we propose the SEC permit VC Fund advisers and managers to use from ten percent up to twenty percent (10%-20%) of their capital commitments for any purpose, without jeopardizing the VC Fund adviser's exemption from registration. This concept is similar to that provided in the comment letter submitted by the National Venture Capital Association (NVCA), in which it proposes a fifteen percent safe harbor. See NCVA Comment Letter, dated January 13, 2011. We thought of the safe harbor concept independently, but believe a range of 10% to 20% of VC Fund commitments provides better flexibility for VC Fund advisers than a hard figure of fifteen percent. Moreover, the articulation of the range, rather than "up to twenty percent," reflects the fact that VC Fund managers will likely make various rounds of financing available to their operating companies over time.

Assuring VC Fund advisers the flexibility to offer a variety of financing opportunities, over time, to their portfolio companies, without the risk of losing the exemption from registration, should be of paramount concern to the SEC, as it is to us. Only the VC Fund advisers/managers are in a position to determine what best form "down-round" financing should take. Whether that should be new capital, project finance, a bridge loan, or some other form of equity or debt, is neither a question for the regulators nor should it be a question of strict regulatory control. The VC Fund advisers will always be in a better position to manage their portfolio companies, and safeguard VC Fund investments. Accordingly, any definition adopted by the SEC that defines VC Fund, should permit VC Fund advisers more flexibility in their financial management than does the proposed definition.

The prohibitions on debt, and other forms of financing, set forth in the SEC's proposed rule result in insufficient discretion for fund advisers to meet their obligations to the VC Fund and its investors. If a VC Fund adviser/manager determines, for example, that a later stage company can incur some form of debt to finance a portion of its operations, the manager should be able to arrange such financing without fear that the adviser will lose its exemption from SEC registration. If the fund manager decides to issue debt to the operating company, that decision would not conflict with the interests of equity holders in that portfolio company. This is because the equity will have been, in the main, supplied by the same group of investors as those who issue the debt. By providing the debt financing, they would not seek to undermine their equity positions in the operating company. In this way, characteristics of the debt used by VC Fund advisers/managers stand in contrast to those debt characteristics used by advisers in private equity fund transactions.

Although we believe the existing California definition of VC Fund provides the optimal flexibility for VC Fund advisers, we request the Commission adopt the approach that we suggest here, which permits VC Fund advisers/managers to use between ten percent and twenty percent of VC Fund assets for debt, or other forms of financing, of portfolio company operations, without jeopardizing any exemption from SEC registration.

Respectfully yours,

Preston DuFauchard
Commissioner