

September 10, 2004

**VIA FACSIMILE**

State Securities Board  
P. O. Box 13167  
Austin, Texas 78711-3167  
Attention: David Weaver, General Counsel

Re: Proposed Changes to 7 TAC §109.3 – Investment Adviser Registration

Dear Mr. Weaver:

The National Venture Capital Association (the “NVCA”) represents approximately 450 venture capital and private equity firms throughout the United States, many of which actively invest in Texas-based companies. These NVCA member firms are currently invested in over 5000 portfolio companies. United States companies originally funded with venture capital now represent 11% of annual GDP and employ over 10 million Americans. The NVCA's mission is to foster greater understanding of the importance of venture capital to the United States economy, and support entrepreneurial activity and innovation. The NVCA represents the public policy interests of the venture capital community, strives to maintain high professional standards, provide reliable industry data, sponsor professional development, and facilitate interaction among its members.

This letter is written in response to your invitation for comments regarding the proposal published in the August 13, 2004 issue of the *Texas Register* to amend Section 109.3 of the Board’s Rules and to add new Sections 109.4, 109.5 and 109.6. Specifically, we urge the Board to elect *not* to adopt Section 109.6(b)(1) as proposed (the “Proposed Amendment”).

As described more fully below, we are of the opinion that the Proposed Amendment would result in an unnecessary regulatory expense and invites confusion regarding a fundamental exemption under the federal and state securities laws for investors that are “accredited.” In our view the Proposed Amendment could also likely result in a significant decrease in capital formation and investment in Texas, as well as negatively impact employment by Texas-based, venture-backed companies.

1. There is No Basis to Reject the Traditional Definition of “Accredited Investor” That Includes Natural Persons, as Currently Employed by Both Texas and the Federal Securities Laws. Both the federal securities laws and Texas state securities laws rely on the traditional definition of “accredited investor” contained in Rule 501 promulgated under the Securities Act of 1933 for purposes of determining the availability of exemptions from various registration, qualification and filing requirements. This definition of “accredited investor” under both federal securities laws and Texas securities laws extends both to institutions and individuals, provided that they satisfy certain

objective requirements, including relevant experience with investing, net worth and income levels, and overall wherewithal to sustain potential investment losses. These exemptions reflect the longstanding recognition that these types of investors are sophisticated and capable enough to evaluate their own investment decisions.

Further, this accredited investor definition, including natural persons as accredited investors, is and has been applied equally to establish suitable exemptions under federal and state laws for the issuance of securities by operating companies to investors and for the issuance of interests in funds, such as venture capital funds, that pool capital under the management of a general partner for investment in securities of operating companies.

However, the Proposed Amendment rejects this understanding and offers no distinction among individuals based upon their abilities to protect themselves due to expertise, net worth or other criteria for the purposes of investment through venture capital and private equity funds.

(a) We do not see a compelling rationale to exclude natural persons or entities comprised of natural persons from the definition of accredited investor solely for purposes of venture capital and private equity funds. The Securities and Exchange Commission (“SEC”), in the course of its comprehensive review of the hedge fund industry, has most recently reiterated its endorsement of the sufficiency of the current accredited investor standard that includes natural persons meeting the requirements set forth in Rule 501.<sup>1</sup> We are not aware of any empirical data supporting the exclusion of natural persons entirely from the definition of accredited investors for the purposes of regulating general partners and fund managers. By eliminating the ability of any natural person (or entity composed of natural persons) to qualify as “accredited investor” for purposes of the Proposed Amendment, the standard would sweep too broadly. Implicit in the policy aims of the Texas securities laws is the distinction between investors who can protect themselves, such as accredited investors, and others who cannot.

Further, the mere aggregation of accredited investors with similar investment interests into an entity comprised entirely of accredited investors should not dilute knowledge or experience, rather, it would seem to improve upon it. The sophistication of individual accredited investors is not lessened by the vehicles through which they choose to invest in certain issuers. In our experience, the use of such an entity by individuals does not serve to circumvent the accredited investor requirements, as the current accredited investor exemption tests already require a “look through” approach to determine whether all of the individuals or other members of the entity separately satisfy the accredited investor requirements as if on a stand-alone basis.

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<sup>1</sup> “[T]he Commission is not aware of any systematic investor losses or other failures caused by the current accredited investor standard.” Chairman William H. Donaldson, U.S. Securities and Exchange Commission, *Testimony Concerning Investor Protection Implications of Hedge Funds*, (Before the Senate Committee on Banking, Housing and Urban Affairs) (April 10, 2003), *available at* <http://www.sec.gov/news/testimony/041003swhd.htm>.

In sum, we do not understand why a natural person, or entity comprised of natural persons, otherwise meeting the traditional definition of “accredited investor” should no longer be considered sufficiently sophisticated once part of a venture capital or private equity fund comprised entirely of accredited investors and therefore cause such fund to fail to meet the revised standard of “accredited investor” set forth in Section 109.6(b)(1). That this distinction would become the basis for requiring the registration of a general partner or fund manager under the Proposed Amendment does not appear to further the investor protection objectives of the Board.

(b) The Proposed Amendment would establish a confusing, inconsistent and unnecessary dual standard. Many states maintain the same or substantially the same standard for accredited investor exemptions, thereby facilitating uniformity and coordination between federal and state exemptions for capital financing and fund formation through the issuance of securities.<sup>2</sup>

Under the Proposed Amendment, natural persons and entities composed of natural persons would be excluded from the definition of accredited investor for purposes of the exemption set forth in Section 109.6(b)(1), upon which managers of venture capital and private equity funds would rely in making the determination that they are not required to register as an investment adviser. Based upon our experience, however, we believe that “accredited investors,” including natural persons, engage in at least the same level of diligence in making a decision to invest in a venture capital or private equity fund and in choosing a general partner or fund manager as they would to invest directly in the securities of one particular business.

Further, the elimination of natural persons from the definition of accredited investor for purposes of venture capital and private equity funds introduces a conflict with the rules for capital financing by companies. As a result, an ironic and unintended consequence of the Proposed Regulation would be that an individual investor could invest directly in the securities of a business company, relying on the standard definition of an accredited investor, yet if the same individual were to invest in a venture fund that in turn invested in the same business company, the venture fund manager would need to be a registered investment adviser.

2. The Proposed Amendment Would Likely Drive Talented General Partners and Fund Managers Out of Texas and Reduce Investment Opportunities to Sophisticated Texas Investors. If the Proposed Amendment is adopted, the administrative costs and competitive disadvantages to registration will likely dissuade firms from opening and maintaining offices in Texas. Indeed, the burdens of registration could cause general partners and fund managers based outside of Texas to avoid Texas’ unique regulation altogether by simply declining to maintain a place of business in Texas.<sup>3</sup> Many other

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<sup>2</sup> See, e.g., Report on the Uniformity of State Regulatory Requirements of Offerings of Securities That Are Not “Covered Securities,” Pursuant to Section 102(b) of the National Securities Markets Improvement Act of 1996, U.S. Securities and Exchange Commission (October 11, 1997), *available at* <http://www.sec.gov/news/studies/uniformity.htm>.

<sup>3</sup> See Section 222(d) of the Investment Advisers Act of 1940 and the exemption in Section 116.1(b)(2)(A)(iv) of the Rules.

states have no similar restrictions. As a result, not only will the pool of successful fund managers in Texas be reduced, but so necessarily will the number of resident investors offered such investment opportunities. If the Proposed Amendment does not exempt a category of natural persons who can protect themselves, venture capital and private equity funds will likely reject all individual investors to avoid the burdens of registration. Thus, resident high net worth investors will direct precious capital to funds managed by general partners and fund managers outside of Texas. Indeed, as a general matter, the undesirable regulatory impositions of registration and the reduction in available investors covered by the exemption in Section 109.6(b)(1), will likely reduce the amount of contact that this highly profitable investment class will maintain with Texas.

We do not believe that there is a colorable public benefit to increasing the protection to high net worth individuals with the resources to have the opportunity to make investments in venture capital and private equity funds. We believe the result will be significant cost and disadvantage to Texas businesses, employees and resident investors. By hampering the ability of sophisticated, high net worth individuals from investing in Texas-based venture capital and private equity funds advised by some of the most experienced, successful managers, the Proposed Amendment would not only disadvantage the same individuals the legislation would presumably be designed to protect, but would also have a deleterious effect on Texas fund managers and sophisticated investors as a whole.

3. The Proposed Amendment Could Reduce Investment in Texas-Based Companies and Negatively Impact the Significant Employment Generated by Venture-Backed Companies Headquartered in Texas. In 2003 alone, venture capital-supported firms headquartered in Texas generated nearly 900,000 jobs across the nation, putting Texas among the top states leading the nation in employment by venture-backed firms headquartered in their state in 2003.<sup>4</sup> In Texas, sales by venture-backed companies reached nearly \$190 billion in 2003, second only to California.<sup>5</sup> However, if the Proposed Amendment is adopted, successful venture capital and private equity fund managers with offices in other states would likely decline to maintain offices in Texas and reduce or eliminate contacts here, thereby removing Texas from the stream of lucrative private equity commerce and venture capital activity crucial to new businesses. As not only capital formation, but the direction of capital to Texas businesses itself would decrease, so would employment at Texas-based, venture capital-backed firms. The significant contributions of the venture capital and private equity fund asset class to Texas-based businesses counsels against the adoption of the Proposed Amendment because venture capital provides a crucial start to businesses and results in increased employment.

### Conclusion

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<sup>4</sup> Global Insight Study, *Venture Impact 2004: Venture Capital Benefits to the U.S. Economy*, available at <http://www.nvca.com> (July 20, 2004).

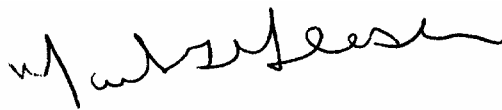
<sup>5</sup> *See id.*

Based upon the experience of the venture capital and private equity industry, it is our view that experienced, wealthy and knowledgeable investors meeting the “accredited investor” standard of the federal securities laws to make investment decisions, including investments in venture capital and private equity funds, does not give rise to public concern or the need for additional and separate regulatory oversight in Texas. Accordingly, we do not believe that there is any justification to diverge from the locally and nationally recognized accredited investor standard to expand the scope of regulatory protection to accredited investors who are natural persons or entities comprised of individual accredited investors sufficiently equipped to protect themselves in these transactions.

If adopted, the Proposed Amendment would result in regulations with one interpretation of accredited investors that includes natural persons and entities comprised of natural persons for certain exemptions and requirements, and yet another standard excluding those sophisticated individuals and entities for the purpose of investment in venture capital and private equity funds. It would be incongruous to have a regulatory scheme distinguishing individual accredited investors sufficiently sophisticated to invest in one or more issuers directly from those investing through venture capital and private equity funds pooling capital and resources for the same purposes of a profitable return on investment. The potential anomaly invites confusion and ultimately avoidance of the state’s regulatory regime, which would undermine its stated goal.

For the reasons detailed above, we believe that the Proposed Amendment would have unintended and unfavorable consequences for the venture capital and private equity industry in Texas, as well as harmful effects on capital formation and direction to businesses in this state. Thank you for consideration of our comments. We would be pleased to discuss our views with the Board in greater detail at the Board’s convenience.

Sincerely,

A handwritten signature in black ink, appearing to read "Mark Heesen", written in a cursive style.

Mark Heesen  
President