



April 14, 2017

The Honorable Mike Crapo  
Chairman  
U.S. Senate Committee on Banking,  
Housing, and Urban Affairs  
534 Dirksen Senate Office Building  
Washington, DC 20510

The Honorable Sherrod Brown  
Ranking Member  
U.S. Senate Committee on Banking,  
Housing, and Urban Affairs  
534 Dirksen Senate Office Building  
Washington, DC 20510

Dear Chairman Crapo and Ranking Member Brown:

On behalf of our nation's venture capital investors and the entrepreneurs they support, I write to express our thoughts on ways to increase economic growth and enable consumers, market participants and financial companies to better participate in the economy in response to your request for legislative proposals.

Young companies, many of which are supported by venture capital investment and mentorship, create an average of 3 million new jobs a year and have been responsible for almost all net new job creation in the U.S. in the last forty years. From FedEx to Genentech, startup entrepreneurs have fueled economic growth and expanded opportunities for the American worker. The American entrepreneurial spirit is key to expanded economic opportunity in the U.S., but is not being fully realized due to a number of challenges we see in the public markets as well as from the unintended consequences stemming from misguided regulations.

In our attachments below, we offer three proposals that would bolster the entrepreneurial ecosystem in order to encourage U.S. economic growth and expand economic opportunity to more areas of the country. Specifically, we request that the committee (1) Exempt investment in venture capital from the Volcker Rule; (2) Modify the venture capital exemption from registered investment advisor (RIA) requirements to fully exempt venture capital activity; and (3) Prioritize capital markets reforms to encourage more U.S. IPOs.

As your committee explores these and other ideas to increase economic growth, we encourage you to not lose sight of the critical role venture capital plays in spurring economic growth in the country. Through patient capital investment and hands-on mentorship with entrepreneurs, venture capital is the rocket fuel that propels innovation and builds emerging growth companies to become leaders of the American economy. NVCA and our member firms stand ready to work constructively with you on commonsense areas of reform. Thank you for

your attention to this important matter. We are encouraged by the conversation and excited to work with you on solutions to jumpstart economic growth through new company formation.

Sincerely,

A handwritten signature in black ink that reads "Bobby Franklin". The signature is written in a cursive, slightly slanted style.

Bobby Franklin  
President and CEO

Enclosures (3):

1. Proposal to Exempt Investment in Venture Capital from the Volcker Rule
2. Proposal to Modify the Venture Capital Exemption from Registered Investment Advisor (RIA) Requirements
3. Proposal to Prioritize Capital Markets Reform to Encourage More U.S. IPOs

## **PROPOSAL TO EXEMPT INVESTMENT IN VENTURE CAPITAL FROM THE VOLCKER RULE**

### ***Brief description:***

Specific to the impact of the Volcker Rule on the entrepreneurial ecosystem, NVCA proposes a clear exemption for venture capital funds from the definition of “covered fund,” which governs a prohibition on banking institution’s ability to contribute capital to private funds.

A narrow definition of venture capital fund that can form the basis for an appropriate definition is included in rule 203(1)-1 under the Investment Advisers Act. The definition was crafted by the Securities and Exchange Commission (SEC) at the direction of Congress, which called for venture capital funds to be exempted from the Registered Investment Advisor (RIA) requirements contained in Dodd-Frank. This definition defines a venture capital fund as a private fund that meets the following:

- A) Represents itself as pursuing a venture capital strategy to its 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;
- 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.

Unfortunately, this definition ignores critical elements of the entrepreneurial ecosystem that must be included in the Volcker Rule exemption to ensure that the proposal fully benefits economic growth and expanded economic opportunity. NVCA recommends the following modifications:

- Investments in Emerging Growth Companies (EGCs), whether public or private companies, should be considered qualifying investments. In addition, the purchase of qualifying investments on the secondary market should not be disqualified;
- Investments in other venture capital funds, including fund-of-funds investments, should be considered qualifying investments; and
- The leverage limitations should be modified to allow for leverage up to the sum of total unfunded commitments, with a term of indebtedness up to 365 days.

These additions will allow banks to invest in a number of entities important to entrepreneurial capital formation, including venture capital fund-of-funds and growth equity investors who are not currently eligible under the SEC definition despite their prominent role in venture capital.

*Impact on the ability of consumers, market participants and financial companies to participate in the economy:*

By limiting the pool of possible limited partner investors into venture capital funds, the Volcker Rule currently reduces the amount of capital available to American entrepreneurs. Perhaps most critical among these are entrepreneurs in emerging ecosystems, many of which are in economically distressed areas of the country. The more challenging reality of venture fundraising in emerging ecosystems tends to require investment from a more diverse set of limited partners. In fact, removing the three most significant states for venture capital activity (CA, NY, MA), the median size venture capital fund size in the U.S. is about \$20 million, simply too small for many institutional investors that make larger contributions to the biggest funds.

Before the passage of the Volcker Rule, banks were an important source of investment for a number of small and regional venture capital funds.

The exemption in the Volcker Rule allowing banks to invest in Small Business Investment Companies and the comments of the bill's sponsors and supporters show a willingness to avoid interfering with entrepreneurial capital formation in the record surrounding passage of the Volcker Rule:

- Chairman Chris Dodd: "Properly conducted venture capital investment will not cause the harms at which the Volcker Rule is directed."
- Senator Boxer: "Section 619 [of the Dodd-Frank Act] explicitly exempts small business investment companies from the rule, and because these companies often provide venture capital investment, I believe the intent of the rule is not to harm venture capital investment."
- Chairman Dodd (in response to Senator Boxer): "[Senator Boxer's] understanding is correct...I expect the regulators to use the broad authority in the Volcker Rule wisely and clarify that funds that invest in technology startup companies, such as venture capital funds, are not captured under the Volcker Rule."
- Senator Sherrod Brown: "Venture capital investments help entrepreneurs get the financing they need to create new jobs. Unfairly restricting this type of capital formation is the last thing we should be doing in this economy."
- Representative Anna Eshoo: "I expect the regulators to use the broad authority in the Volcker Rule wisely and clarify that funds that invest in technology startup companies, such as venture capital funds, are not captured under the Volcker Rule."

Unfortunately, the reality today is different. Regulators did not exempt investment in venture capital funds, and since the passage of Dodd-Frank a number of venture capital funds have lost investment from banks and companies with significant financial arms. Some lost the investment almost immediately whereas others went to raise a new fund and were turned down by banks that had invested previously but declined to do so going forward due to the Volcker Rule. Critically, many of these venture capital funds that NVCA has heard from have been in less-traditional regions for venture capital which are fighting to build out their emerging entrepreneurial ecosystems.

Perhaps most perplexing is that restricting investment into venture capital does nothing to accomplish the objective of the Volcker Rule, which is to prevent systemic risk that may arise through risky proprietary trading by financial institutions. Venture capital poses no systemic

risk. Typically, venture capitalists commit equity investments for periods of five to ten years into startups and emerging growth companies, and work hand in hand with the leadership team to grow them into successful enterprises. While many startups do not succeed, the risk of venture capital investment is generally limited to the capital committed. Further, venture capital mitigates the risk of financial institutions investing directly in high growth startups (which is currently permitted under the Volcker Rule) by pooling a number of investments in a fund with gains from the successful investments offsetting the losses from the unsuccessful.

If no changes are made, Congress will continue to limit the growth prospects for a number of emerging regions, with no perceivable public policy benefit.

***Impact on economic growth:***

Recent research has found that young companies create an average of 3 million new jobs a year<sup>1</sup>, and are responsible for almost all net new job creation in the United States<sup>2</sup>. Further, while venture capital has invested in less than one percent of startups since 1974, venture-backed companies have been responsible for 42 percent of IPOs since then, and account for 85 percent of all public company R&D investment among this subset<sup>3</sup>.

When it comes to job creation, innovation, economic growth and economic competitiveness, there is no area of the economy more critical to success than the entrepreneurial ecosystem.

Because startups must operate for years in a loss position or are even completely pre-revenue in many cases, investment capital is the fuel that can determine success or failure. Unfortunately, the Volcker Rule's prohibition on financial institution investment into venture capital creates an unnecessary roadblock for capital formation, particularly in underserved areas where raising capital for venture capital investment tends to be more difficult.

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<sup>1</sup><http://www.nber.org/papers/w16300.pdf>

<sup>2</sup> <http://www.kauffman.org/what-we-do/resources/entrepreneurship-policy-digest/the-importance-of-young-firms-for-economic-growth>

<sup>3</sup> <https://www.gsb.stanford.edu/faculty-research/working-papers/economic-impact-venture-capital-evidence-public-companies>

## **PROPOSAL TO MODIFY THE VENTURE CAPITAL EXEMPTION FROM REGISTERED INVESTMENT ADVISOR (RIA) REQUIREMENTS**

### ***Brief description:***

NVCA is grateful for the exemption provided by statute that was intended to exempt all venture capital funds from the costs and challenges associated with the RIA registration requirements under Dodd-Frank. However, the definition of venture capital fund promulgated by the Securities and Exchange Commission in rule 203(1)-1 of the Investment Advisers Act was too narrow and did not meet the statutory obligations of a full venture capital exemption. The definition leaves out broad swaths of growth equity and fund-of-funds venture capital firms, constrains the investment activity of some Exempt Reporting Advisors (ERAs) who must actively avoid the regulatory morass of registration, and imposes unnecessary compliance burdens on other firms who participate in venture capital.

The definition defines a venture capital fund as a private fund that meets the following:

- A) Represents itself as pursuing a venture capital strategy to its 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;
- 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.

Unfortunately, this definition ignores critical elements of the entrepreneurial ecosystem that must be included to ensure that the venture capital definition most fully benefits economic growth and expanded economic opportunity. NVCA recommends the following modifications:

- Investments in Emerging Growth Companies (EGCs), whether public or private companies, should be considered qualifying investments. In addition, the purchase of qualifying investments on the secondary market should not be disqualified;
- Investments in other venture capital funds, including fund-of-funds investments should be considered qualifying investments; and
- The leverage limitations should be modified to allow for leverage up to the sum of total unfunded commitments, with a term of indebtedness up to 365 days.

There should be a simple and timely deregistration process for currently registered venture capital funds who would be exempt due to these modifications.

These modifications will create a more accurate definition of venture capital fund, easing the regulatory burden on entities important to entrepreneurial capital formation, including venture

capital fund-of-funds and growth equity investors who are not currently eligible under the SEC definition despite their prominent role in venture capital.

In addition, NVCA believes that certain low-value compliance requirements in the RIA rules should be modified to lower the significant regulatory costs associated with registration. These include:

- **Advertising Rule:** Limit Rule 206(4)-1 to only the most problematic aspects for advisers who offer the relevant marketing materials exclusively to accredited investors, qualified clients, qualified purchasers, or knowledgeable employees. Further, website information that is addressed to entrepreneurs and potential portfolio companies should be exempted from the rules, as long as all potential investor offerees are otherwise provided with compliant marketing materials. Finally, so long as the advisers are complying with anti-fraud provisions and only offer the relevant categories and have the underlying documentation proving their record from their previous firm, the portability rules shouldn't apply.
- **Maintenance of Books and Records:** Modernize the books and records provisions to ensure that the documents requested reflect the realities of today's business environment. This can also help the SEC in understanding by providing a more concise set of documents for review.
- **Investment Advisory Contracts:** Section 202(A)(12) should be amended to increase the change in control presumptive threshold for an assignment from 25 percent to a majority of voting securities.
- **Custody Rule:** The Custody Rule should be limited to only require publicly-traded securities and cash be maintained with a qualified custodian. This should include expanding the "privately offered securities" exemption so that it applies to both certificated and uncertificated securities and so that a private fund can rely on it, even where its investment adviser chooses to use the surprise examination approach rather than annual audit approach.
- **Form PF:** The additional section of Form PF should be removed for growth equity funds, which would place them on the same reporting basis as other private fund sponsors who are not large hedge funds or liquidity fund sponsors.
- **Personal Securities Transaction Reporting:** Personal securities transaction reporting should only be required for annual statements.

***Impact on the ability of consumers, market participants and financial companies to participate in the economy:***

Despite good faith efforts that mitigated a significant amount of potential damage, the Dodd-Frank requirement that some venture capital firms become RIAs is an unnecessary regulatory burden on the entrepreneurial ecosystem. The regulatory requirements provide little public benefit when applied to venture capital funds, which are focused on scaling startups and small businesses into successful companies. But these requirements cost hundreds of thousands (and millions, in some cases) of dollars in annual compliance costs, interferes with ordinary business practices, and can even limit the ability of many ERAs to make certain investments.

The RIA rules mandated by Dodd-Frank have created three major challenges for the entrepreneurial ecosystem:

- The venture capital exemption definition is not a complete definition, and therefore unnecessarily obliges too many firms who participate in the venture ecosystem to register with no significant public policy benefit.
- To avoid the significant pains associated with registration, a number of ERAs find their investment strategies constrained by eligibility requirements that have no bearing on systemic risk. Thus, ERAs will avoid providing investment for some young companies simply to stay away from registration.
- For those who are RIAs, the regulations contain a number of low-value compliance requirements that cost time and money and needlessly distract from their mission. This has led to hundreds of thousands, or in some cases even millions, of dollars in needless compliance costs at growth equity venture capital firms.

***Impact on economic growth:***

Recent research has found that young companies create an average of 3 million new jobs a year<sup>4</sup>, and are responsible for almost all net new job creation in the United States<sup>5</sup>. Further, while venture capital has invested in less than one percent of startups since 1974, venture-backed companies have been responsible for 42 percent of IPOs since then, and account for 85 percent of all public company R&D investment among this subset<sup>6</sup>.

When it comes to job creation, innovation, economic growth and economic competitiveness, there is no area of the economy more critical to success than the entrepreneurial ecosystem.

Because startups must operate for years in a loss position or even completely pre-revenue in many cases, investment capital is the fuel that can determine success or failure. Unfortunately, the costs and complexity arising from the RIA requirements creates unnecessary roadblocks in the entrepreneurial ecosystem despite a clear congressional intent to avoid creating such challenges.

Creating a more accurate venture capital exemption definition will protect the entrepreneurial ecosystem from the economic distortions currently created by the RIA requirements contained in Dodd-Frank, and free up needed capital for venture investment activity.

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<sup>4</sup><http://www.nber.org/papers/w16300.pdf>

<sup>5</sup> <http://www.kauffman.org/what-we-do/resources/entrepreneurship-policy-digest/the-importance-of-young-firms-for-economic-growth>

<sup>6</sup> <https://www.gsb.stanford.edu/faculty-research/working-papers/economic-impact-venture-capital-evidence-public-companies>

## **PROPOSAL TO PRIORITIZE CAPITAL MARKETS REFORM TO ENCOURAGE MORE U.S. IPOs**

### ***Brief description:***

Healthy and accessible capital markets are critical to the entrepreneurial ecosystem and the U.S. economy. But today's public markets are no longer welcoming to innovative, small-capitalization companies. NVCA proposes that Congress mandate a study from the SEC to examine the state of the public markets for small cap companies and identify potential solutions to the pervasive equity capital formation crisis facing small capitalization companies in the U.S. public markets. Congress should require that this study be completed in 180 days.

There are a number of ideas as to why the public markets have become so difficult for small capitalization companies, and they generally fall into three buckets:

- Regulatory challenges;
- Market structure; and
- Market culture

Small cap companies are struggling because, as the cost of being a public company has increased, the infrastructure, and the economics that historically supported small cap companies have disappeared. At the same time, a culture of short-termism has become more prevalent.

There are numerous explanations for why this has happened, but it is important to remember that the U.S. capital markets have undergone a number of significant changes since 2000. The move to decimalization, the passage of Sarbanes Oxley and a number of other regulatory changes, the 2003 global settlement, the computerization of the markets and the rise of high-frequency trading, the disappearance of adequate economic incentives for investment banks to sponsor growth companies in the public markets, and the consolidation among major investment institutions, all have occurred since 2000.

### ***Impact on the ability of consumers, market participants and financial companies to participate in the economy:***

Since 2000 the U.S. has been averaging a third of the number of IPOs per year compared to what we experienced in the 1990s and half of the number of IPOs per year compared to what occurred in the 1980s. The very best year for IPOs since 2000 was 2014 when 207 companies went public, which would have been a mediocre year when compared to the 1980s when we averaged 204 IPOs per year and a poor year when compared with the 1990s when we averaged 409 IPOs per year. A consequence is that over the last 20 years, the U.S. has lost half of the total companies listed on its exchanges. This unfortunately means fewer jobs for American workers and fewer companies for Americans to invest in to save for retirement.

The JOBS Act was a great first step to reopening our public capital markets to startups and small cap companies. The challenge today is that the JOBS Act helped build an on-ramp but the

freeway still needs significant work. Simply put, the public markets need to be a more attractive place for companies, not to just get to, but to also stay in.

***Impact on economic growth:***

This lack of new public companies has been a significant factor in the reduced access to opportunity the country has experienced. In fact, a more conservative estimate of the consequences of a lack of IPOs indicates a loss of about 2 million jobs<sup>7</sup>. Policymakers should focus on solutions that will encourage more startups and Emerging Growth Companies (EGCs) to become public companies in to provide economic growth and create more economic opportunities for American families going forward.

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<sup>7</sup> <https://site.warrington.ufl.edu/ritter/files/2015/04/Senate-Committee-Banking-Housing-Urban-Affairs-Subcommittee-Securities-Insurance-Investment-Testimony-2012-03.pdf>