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A NEW REGULATORY APPROACH TO VENTURE CAPITAL

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I would like to talk to you today about what is usually called the "venture capital problem." My thesis is simple:

-- in this country, a broad government program to allocate credit to high technology industries would be a mistake. The government would be neither an appropriate nor a successful venture capital investor.

-- the flow of funds into venture capital investments is a function of the vigor and health of the secondary equity markets.

-- to the extent that the Federal government acts at all in this area, its role should be confined to eliminating regulatory barriers to flows of capital into the private markets.

This subject is an interesting one, not only because of its fundamental importance to our economy, but because it strikes me as an unparalleled example of muddy thinking on issues of domestic public policy.

Among the topics that usually find their way into this debate are:

-- the importance of raising capital for high technology companies.

-- the inadequacy of the flow of capital to small business generally.

-- the need for increased capital flows to sectors of the economy that have not been able to finance adequate levels of investment (for example, steel and railroads.

-- the need to redress the growing imbalance in corporate debt-equity ratios.

-- the importance of more cooperation, rather than antagonism, between government and business -- the new mercantilism.

-- the imbalances in tax policy that favor consumption over investment and debt over equity.
In short, in addition to the kitchen sink, debates about venture capital have a distinguishing characteristic -- they tend to merge at one end into a general discussion of capital formation issues -- which are largely a matter of tax policy and macro-economic management -- and at the other end into a discussion of credit allocation. To be sure, the credit is not be allocated to the poor or the socially disadvantaged, but to the electronics, data processing, communications, biological engineering or other high technology industries.

**Credit Programs**

Let me begin with the credit allocation issue. No one who has devoted any time to this potpourri of issues could have missed the splendid piece done by the electronics industry about what the failing equity markets of the 1970's and the resulting dry holes of venture capital had done to that industry. The inevitable result of this kind of concern is one of three proposals: general reduction in capital gains taxes, tax policies that favor investment in a particular industry or class of "industries of the future", or a government bank to allocate credit for the same purposes.

Now that I have left the government and I am no longer required to examine all issues with a mind so open it resembles that of a new-born baby, I should confess my predilections. I have no confidence whatsoever in the ability of our government to be a successful venture capital investor. That conclusion is based upon the difficulty of that task, upon history and upon a number of systemic factors.
The Bureau of Industrial Economics has done some interesting analytical work on the subject of the difficulty of "picking winners." Even more compelling is the fact that any extended conversation with professional venture capitalists and an appraisal of their return on investment over time quickly yields the same conclusion.

Second, there is no evidence in the American experience to suggest that the government is a very good allocator of credit to individual companies. An examination of the programs of the Small Business Administration, the Economic Development Administration, the Farmers Home Administration and even, I suspect, the Reconstruction Finance Corporation, yields varied conclusions; none of them would be that our government has had many spectacular investment successes.

Third, there are a number of fundamental reasons for a lack of confidence in the likely result of a Federal venture capital effort. The process of governmental decision-making, both Congressional and bureaucratic, that allocates capital through a credit program is inefficient, even granted the value of its objectives. The pork barrel is an inevitable attendant. No administration can prepare any program for allocating funds according to a formula without trundling to the Congress with a wheelbarrow full of computer print-outs showing the impact of the proposed formula in the districts of each of the relevant Congressional committee members. For example, the Carter Administration's much-vaunted urban development bank proposal
became a national development bank because of the importance of agricultural interests to other part of the President's urban policy.

The process is also inefficient because the absence of profitability as a measure of enterprise (or agency) effectiveness sets the program's creators, administrators and overseers adrift in a sea of ambiguity. In practice, the critical question -- by what standards is the success or failure of a proposed program to be judged? -- is seldom asked, no less answered with any rigor.

Federal credit programs are almost always characterized by multiple, sometimes inconsistent goals, wholly unaccompanied by any fixing of priorities. When ConRail was created out of the shambles of six bankrupt railroads in the Northeast, an elaborate, five-year business plan was developed as the basis for calculating the level of Federal investment. Every corporate strategic planner knows the fragility of any five-year plan, no less one written under the guidance of the Congress to oversee the merger of six bankrupt companies operating in a basic industry in a declining region of the country. The limited usefulness of the plan was pre-ordained. Nevertheless, a competent manager would have began the process of reshaping the business to achieve profitability. But profitability was not the only goal established by the Congress. All of the following goals were reflected in the basic legislation, without priorities:
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- a level of service adequate for the needs and service requirements of the region;
- a financially self-sustaining operation;
- promotion of competition among rail carriers and between rail and nonrail carriers; and
- minimization of adverse impacts on employment and on the local communities of the region.

In the absence of Congressional willingness to fix priorities among those objectives, or even to recognize the tradeoffs among them, the process is inherently undisciplined. If a government official is asked to pursue two conflicting goals without the discipline of an overriding purpose, can that official truly be said to be pursuing either? Accountability becomes a chimera, eluding the Congress and the President at every turn.

This tendency to vagueness and multiplicity of goals is endemic in government programs. By the substitution of a political judgment about the worthiness of a particular activity -- housing, small business, Lockheed, the Northeast railroad system or the Chrysler Corporation -- the Congress brings to at least two, and often a handful, the number of objectives to be served by the program. In addition, the legislative process generates ambiguity. The compromises that James Madison thought would result from the clash of interest groups represented in the Congress are a reality. Compromise is an essential element of the American political process, but it is often only the vagueness of the result that permits compromise to come easily.
Finally, in my judgment one of the central problems of American government lies in the extraordinarily high rate of turnover among senior and upper-middle level officials. That fact makes intelligent planning extremely difficult. In the context of venture capital investments, which ordinarily have a 6-10 year life, it is a well-nigh overwhelming obstacle.

Some people point to the sharp interest of other countries in developing informal and formal credit allocation schemes. They argue that we have never attempted to truly "rationalize" our economy and that the dismal results to date flow from the fact that the government has been always the investor of last resort. It thus inevitably ends up with the less attractive investments. That is certainly true of companies like ConRail, Lockheed and Chrysler and, to the extent that programs like those of the Small Business Administration and the Economic Development Administration require that private investment be unavailable as a precondition to Federal investment, it is also a fair comment about these programs. But that view ignores the systemic nature of the factors discussed above that inhibit effective government investing. Eliminating them in the absence of emergency conditions requires a far more fundamental change in our political system than is likely to occur.

What do we make, then, of the attempts by other countries to launch their governments into venture capital investing. In addition to informal allocation of credit, the Japanese have substantial sums invested in the Japan Development Bank. Prior
to the last Presidential election in France, the French and German governments announced joint plans to raise $6 billion in the international capital markets to increase investment, particularly in high technology areas. And there are other examples.

In many — perhaps most — cases, these efforts represent little more than an attempt by a government to assume the risks (perhaps inefficiencies is a better word) causing the market to impose a very high cost of capital on the industry in question. Those risks may be large start-up losses in the face of a significant technological lead on the part of the industry of another country, or domination of the market by another country or a lack of an adequate domestic infrastructure, human or physical. That enumeration does not end the inquiry, however, for there remains the question why it is in the national interest for this or any other country to assume those risks. It ignores the notion of comparative advantage for a country to do so.

In the case of third world countries, the government's action fills the gap created by the lack of an efficient capital market. But for a country with an effectively functioning capital market, the only real reason for such a step must be found outside of the economic attributes of the investment. A full exploration of that question is beyond my subject today, and I will say only that there may, indeed, be compelling reasons why a country would choose to develop an industry in spite of the inefficiencies of doing so.
For example, the vulnerability of the international delivery system for petroleum is a perfectly good reason for a conclusion that national security requires the development of a functioning synthetic fuels industry more rapidly than would be produced by the market. But we must be on guard against a tendency to ascribe the decision to aid a specific industry to "inefficiencies" or "market failures" that are simply cover stories for externalities like national defense, national prestige, or the like.

Finally, it is also important to recognize that using the income tax to aid specific industries or companies is even more difficult than direct lending. Because tax deductions and credits are such a blunt instrument -- that is, so many companies are ordinarily covered -- there is enormous pressure to create a definition of eligibility that targets the benefits in an appropriate way. I have struggled with the definitional problem at the Treasury, for tax purposes, and at the SEC, for regulatory purposes, and I have concluded that this is not a subject that can be dealt with by definition in a satisfactory way. All of the reasons that make "picking winners" so fraught with failure are magnified in frustrating the search for definitions.

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I would like to suggest a somewhat different basis for a governmental venture capital philosophy that rests upon two propositions:

-- first, that those observers whose discussion of the "venture capital problem" merges into a broader discussion of capital formation and macroeconomic policy are on fundamentally the correct track, and

-- second, that the public securities markets are an efficient mechanism for the delivery and allocation of long term debt and equity -- corporate capital -- and that if there is a venture capital problem, it is in tax and regulatory disincentives to the flow of capital to companies that do not have access to the public markets -- their capital is raised in what, for convenience sake, I will call the private market.

The Importance of the Public Secondary Markets

The first proposition rests on the notion that what motivates the venture capitalist is the ability to make very large returns to compensate for the very large risks he accepts. While tax policy is surely a significant factor for the venture capitalist at the margin, only the leverage afforded by the public market can provide those returns. The potential profits to venture capital investors in Apple Computer and Genentech are recent dramatic examples. In the case of Apple, in which stock was purchased by venture capitalists at prices ranging from 9 cents to $1.30 a share, the stock is currently traded in the low 30's. That increase in value is the sine qua non of venture capital investing. The difference between a 50% tax rate and a zero tax rate is an important element in calculating the venture capitalist's rate of return, but tax rate differentials cannot produce the gains in the first place.
The public markets also provide the second necessary element for a venture capitalist -- liquidity. Once a company has reached the stage where it has access to more conventional sources of capital, the opportunity for a venture capitalist's return is no longer present, and the venture capital investor would rather deploy his assets elsewhere. There are ordinarily only two ways to liquidate the investment -- a sale to the public securities markets or a sale to an acquiring company. The likelihood of the portfolio company being able to repurchase its securities from the venture capitalist is slim, since its very success at this stage means that its need for capital is growing rapidly. When the secondary markets are weak, the venture capitalist's need for liquidity conspires with the portfolio company's need for capital and becomes a force for concentration in the economy. Only a large acquiring company with access to capital satisfies both needs, and that pattern of acquisition by large firms is discernible in certain industries that rose beyond the start-up stage in the 1970's.

Thus both the desire for entrepreneurial rewards and the need for liquidity make the health of the secondary markets the key factor for determining the attractiveness of venture capital investments. Indeed, I would go so far as to guess that tax relief that is specifically tailored to venture capitalists, with the possible exception of a rollover of gains, would not be effective in the absence of healthy secondary markets.
Proponents of tax reform like to point to the increase in the capital gains tax in 1969 as a prelude to the drying up of the venture capital industry in the early and mid-1970's, and the reduction of capital gains rates in 1978 as a prelude to the explosion of venture capital investing over the past few years. The direct impact of those tax changes on the attractiveness of venture capital investing cannot be denied. But their impact on the equity markets generally was even more dramatic. Over the past few years the large increase in first-time public offerings at high multiples has provided a powerful incentive for those interested in early-stage financing.

For example, the flow of new funds to the organized venture capital industry in 1980 totaled approximately $900 million. This is almost triple the amount committed in 1979 ($319 million) and slightly less than double the burst of growth following the 1978 reduction in the maximum capital gains tax ($570 million). Of this estimated 900 million, about $657 million was supplied by private venture capital firms, another $39 million in private capital invested in SBICs, and an additional $200 million from corporate controlled subsidiaries. It is particularly interesting that the largest source of capital flowing into venture capital firms, 29% of the total committed, was supplied by pension funds.\footnote{Source: Venture Capital Journal - December 1980.}
-- which are nontaxable. Thus any impact of tax changes on pension funds must be attributable to the anticipated effect of these changes on the secondary markets. 2/

As for my second proposition, I think it is plain that the public securities markets are an efficient delivery mechanism for capital, and that regulatory costs, such as those imposed by the securities laws, are neither structural barriers nor significant costs at the margin to raising funds in these markets. Of far more significance to the amount of capital available in the public markets is the level of Treasury financing and various credit allocation devices.

The Private Markets

That conclusion suggests that we should look at the venture capital "question" as one of the adequacy of the private markets for the raising of capital and the impact of regulatory actions on those markets. That is almost never done. While articles about venture capital financing, and institutional private placements, or oil and gas financing abound, I know of no regulatory agency, including the SEC, that views this private market as a whole.

I would like to use the time that remains to sketch out the regulatory approach traditionally taken by the Commission and other regulators and compare it with some of this market.

The evolution of the SEC's private placement exemption from registration is probably as good a place to start as any. The Securities Act of 1933 simply excludes from the registration requirement sales of securities by an issuer "not involving a public offering". Administrative elaboration and judicial decisions have put a complex gloss on that language, requiring an absence of public solicitation or selling effort, sophistication and ability to bear the loss on the part of the investor, and access for investors to the same kind of information as would be available in a registration statement. Under the statutory framework, exemption from registration is the exception rather than the rule, and the burden of proof is on the issuer to justify that treatment.

Before moving on, let me pick another example from a different area -- ERISA's prudent man rule. The common law governing the fiduciary obligations of trustees developed to deal with the problem of regulating the conduct of trustees of trusts established under wills and other arrangements where the only supervision of the trustee came in a formal court proceeding after all of the duties were performed. It sought to balance the interests of those with a present, life interest in the trust, with the interests of others who were to receive the principal at a later date. Each investment was judged on its own merits without regard to the composition of the whole portfolio. When ERISA was adopted and Federal standards were established for pension fund investments, the prudent man rule, which had been developed to
exclude unduly risky investments from trust activities, was carried over into Federal law.

In both cases, the steps taken made sense as an element of the regulatory system of which they were part. But these concepts were developed -- especially in the securities laws -- without reference to the characteristics of the private market to which they are so important. So let me step back for a moment and look at some of the characteristics of that market.

The venture capital market is essentially a subset of the broader private placement market. At a minimum, that broader market is composed of the following elements:

-- The institutional private placement market for corporate debt and equity (largely preferred stock) securities. This market, in which the investors are principally insurance companies and pension funds, has accounted for 20% - 40% of all external capital raised by industrial companies in recent years.

-- The market for nonpublic oil and gas ventures.

-- Private real estate ventures.

-- Professional venture capital firms, which I will discuss at greater length in a moment.

-- Informal investors. It is plain that many companies begin without the aid of professional venture capitalists. Indeed, separate individual investors are probably more apt to be found in true start-up situations than formal venture capital pools. Although this is obviously a very important part of the private market, almost no data is available. A recent study sponsored by the SBA of informal risk capital in New England estimates that financing from this source is at least as large, and probably larger, than the level of investment by SBIC's.

A few observations are in order at this point. First, in thinking about tax and regulatory policy, the institutional
private placement market should be put in a class by itself. That market is composed principally of insurance companies and pension funds purchasing long term debt securities and preferred stock of substantial companies. Those investments are typically made for income and are held to maturity. With limited exceptions, the secondary market is not important. The institutions have no need for the protection of the registration provisions of the Securities Act. Life insurance companies are subject to a unique income tax regime, and pension funds are nontaxable entities.

The second observation is that the traditional venture capital market has become heavily institutional in character. This trend, which has occurred, over the past 15 years is seen both in the sources of venture capital funds (the movement away from family and individual money to pension, corporate and insurance sources) and in the management of these funds by an organized, professional venture capital industry. One might easily view the growth of the industry as a direct effect of the more passive management role chosen by institutional investors in venture enterprises. In the late 1960's, encouraged by a booming equity market and feverish expectations, corporations, pension funds and insurance companies sampled direct involvement in venture capital investing. The experience was not rewarding due to a number of factors, including the 1974-75 recession and slack secondary markets. The organized venture capital industry has worked to develop
investment vehicles suitable for fiduciary investment -- the result is 200-250 active venture capital firms with professional expertise and proven track records managing a pool of approximately $4.5 billion.

In 1980, pension funds supplied about 30% of new funds for venture capital firms and corporations were the second largest source at 18%. Life insurance companies accounted for 13% of the total (compared to 4% in 1979), and individual and family contributions fell to 17%.

Third, if we focus on the private market as a whole, it is clear that there are important similarities, from a regulatory point of view, between venture capital investments and privately placed investments in both oil and gas drilling programs and real estate limited partnerships. Both represent major areas in which national policy favors the flow of capital. The importance of discovering additional sources of domestic energy needs no further comment. And our commitment to a national housing policy is reflected in the intentional preservation by the Congress of tax shelter aspects for certain real estate projects. While some energy and real estate projects are financed in the public markets, most financing is done in the private market. As in the case of venture capital, the financing for these projects is becoming increasingly institutional in character, especially in the case of oil and gas financing. A recent article reported that Prudential Life Insurance Company plans to devote over $400 million this year alone to investments in oil and gas drilling programs.
I would like at this point to bring you back to my brief examples of regulatory policy: the ERISA prudent man rule and the SEC's private placement exemption. In the case of ERISA, a lengthy comment process has brought the rule to a sensible and workable state. Unlike common law trusts, the investment managers are subject to constant scrutiny and there is a continuing appraisal of their performance. So the old rigidity is not functional in this new environment. Moreover, it is very clear that, as the private markets become increasingly institutional, rules that have the effect of barring institutions begin to become serious barriers to capital flows. To be sure, there are other reasons why institutions may hesitate to make venture capital investments, not the least of which are the high surveillance costs of venture capital investments in relation to their size and a high preference for liquidity on the part of many institutions. But the early, conservative interpretations of the prudent man rule were clearly problems for pension fund investors.

The private placement exemption is another very clear example. A high percentage of the private placements involving individuals do not qualify under the stringent standards established for that exemption. Moreover, although the Commission has moved to bring greater certainty and ease to both the exemption (through its Rule 242) and public registration (through its Form S-18), real estate and oil and gas limited partnerships have been excluded from those more attractive routes. That is in the process of change, but, again, this
18. approach illustrates what seems to me to be a failure in financial regulation -- a lack of understanding of the nature of the private markets. Nothing better illustrates that lack of understanding than the current absence of data. The revolutionary nature of the study of informal investors in New England is really just another way of saying that we do not have a good grasp of what people are actually doing in this market. And there is little or no data about the level of private placements in oil and gas and real estate.

But one thing is clear. The SEC has a Rule 146 which has come to be widely used for non-institutional private placements. That rule was adopted in May of 1978. From its adoption through March of this year there were over 13,000 Rule 146 offerings raising over $18 billion. Even though I suspect that many of these offerings do not really comply with Rule 146, it is very clear that there would be no public policy served by trying to force those offerings into the registration statement process. As a matter of practice, there have been few SEC enforcement proceedings against private placements unless there is also strong evidence of fraud. I think we should go further in recognizing that fact and loosening the registration requirements for private placements. In effect, we should recognize that the antifraud rules are, and ought to be, the privacy regulatory tool in this area.

Finally, I would like to leave you with an example of what I think is the correct approach to venture capital.
With the exception of a few SBIC's, venture capital pools have raised their funds exclusively in the private markets. There are some fundamental reasons that make venture capital a less than ideal medium for public investors:

-- valuation is extremely difficult until the portfolio investments begin to top the public markets.

-- it is often difficult to know whether or not the investments were a success for the first 5 - 7 years.

-- the compensation of management, which typically includes a share of capital gains, is often very high.

Above and beyond that, however, the Investment Company Act and the Investment Advisers Act imposed some regulatory barriers that made venture capitalists shy away:

-- the Act prohibits transactions with affiliated parties, which are very broadly defined, without permission of the SEC. The massive rounds of financing typical in a venture capital investment make such transactions inevitable -- and the length of time consumed in securing SEC approval made that route impractical.

-- the typical compensation structure, in which managers are given a share of the gains, was prohibited.

-- the capital structure requirements of the Act imposed all sorts of unreasonable requirements.

After a modicum of Senatorial coercion, the Commission agreed to legislation which was adopted last year as the Small Business Investment Incentive Act of 1981. That Act grants substantial relief in all of those areas, plus others, but only to venture capital companies -- then called business development companies. In trying to separate the treatment of business development companies from all other investment
companies, we were brought face to face with the definitional problem. We solved the problem by requiring that a qualifying business development company make significant managerial assistance available to its portfolio companies and have at least 70% of its investments in companies that either have no public market for their securities or, if there is such a market, are not registered on any exchange or on the Federal Reserve's OTC Margin List. That list, of course, is a proxy for companies which, while publicly held, do not have enough investor interest to really be able to finance in the public markets. It is an interesting approach, and one that requires close examination as time passes.