MEMORANDUM

April 4, 2011

To: File S7-37-10 (Advisers Act Release 3111)
File on Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**")

From: Tram N. Nguyen
Office of Investment Adviser Regulation
Division of Investment Management

Re: Meeting with SVB Capital ("**SVB**")

On April 4, 2011, representatives of SVB met with staff from the Division of Investment Management ("**IM**") of the Securities and Exchange Commission ("**SEC**") and staff of the Commodity Futures Trading Commission ("**CFTC**").

The representatives of SVB that met with SEC staff were: Sven Weber and Mary Dent of SVB, and Satish M. Kini and David A. Luigs of Debevoise & Plimpton LLP.

The following members of the SEC IM staff were present: Eileen P. Rominger, Director, David A. Vaughan and Tram N. Nguyen.

The following members of the CFTC were present: Paul Schlichting and Daniel Konar.

The topics of discussion were: the proposed definition of "venture capital fund" and the restrictions on hedge fund and private equity fund investments under Section 619 of the Dodd-Frank Act. SVB submitted the attached materials at the meeting.

SVB›Financial Group

SVB Financial Group

March 2011

SVB At A Glance

- *Founded in 1983*
- *26 offices across the United States*
- *International offices in China, India, Israel and the U.K.*
- *13,000+ clients and 1,350+ employees*
- *50% of VC-backed U.S. companies and VCs worldwide are clients*

Commercial Banking and Lending

Valuations & Equity Management

Private Banking

Global Markets

Funds Management

The Innovation Ecosystem

Venture Investors

- Equity investments to transform ideas into reality
- Business expertise & networks
- Hands-on involvement
- *Typically work with portfolio companies for 5-10 years*

SVB

- Debt financing with a "steady hand"
- Banking products & services to support the business
- Knowledge and programs to promote entrepreneurs' success and build the ecosystem
- Community involvement

High Growth Technology Startups

U.S. ECONOMY

- **12.1 million jobs – 11% of total private sector employment**
- **$3 trillion in revenues – 21% of U.S. GDP**
- **Transformative technologies and industries**
  - **How we live and work**
  - **How we treat and cure diseases**
  - **How we entertain ourselves**
  - **Energy independence and environmental sustainability**
- **U.S. exports and global competitiveness**
- **U.S. productivity**
- **Corporate growth**

Key Attributes of Venture Capital Funds

1. Long Term Investment Horizon	• 10+ year fund term • No redemptions absent extraordinary circumstances • Company investments are held for years
2. Limited Use of Leverage	• Fund borrowing generally limited to short-term needs • Debt not used to financially engineer returns • Capital-intensive companies require debt (cleantech)
3. Investments in Private Companies	• Primarily invest in privately-held companies • Public market investments are rare (PIPE investments)
4. Non-Controlling Investments	• Minority ownership over time • Investments alongside management (not buyout)

SVB>Financial Group

SVB›Financial Group

SVB Financial Group

March 2011

SVB At A Glance

- *Founded in 1983*
- *26 offices across the United States*
- *International offices in China, India, Israel and the U.K.*
- *13,000+ clients and 1,350+ employees*
- *50% of VC-backed U.S. companies and VCs worldwide are clients*

Commercial Banking and Lending

Valuations & Equity Management

Private Banking

Global Markets

Funds Management

The Innovation Ecosystem

Venture Investors

- Equity investments to transform ideas into reality
- Business expertise & networks
- Hands-on involvement
- *Typically work with portfolio companies for 5-10 years*

SVB

- Debt financing with a "steady hand"
- Banking products & services to support the business
- Knowledge and programs to promote entrepreneurs' success and build the ecosystem
- Community involvement

High Growth Technology Startups

U.S. ECONOMY

- 12.1 million jobs – 11% of total private sector employment
- $3 trillion in revenues – 21% of U.S. GDP
- Transformative technologies and industries
  - How we live and work
  - How we treat and cure diseases
  - How we entertain ourselves
  - Energy independence and environmental sustainability
- U.S. exports and global competitiveness
- U.S. productivity
- Corporate growth

Key Attributes of Venture Capital Funds

1. Long Term Investment Horizon	• 10+ year fund term • No redemptions absent extraordinary circumstances • Company investments are held for years
2. Limited Use of Leverage	• Fund borrowing generally limited to short-term needs • Debt not used to financially engineer returns • Capital-intensive companies require debt (cleantech)
3. Investments in Private Companies	• Primarily invest in privately-held companies • Public market investments are rare (PIPE investments)
4. Non-Controlling Investments	• Minority ownership over time • Investments alongside management (not buyout)

SVB›Financial Group

SVB>Financial Group

November 5, 2010

Financial Stability Oversight Council
c/o United States Department of the Treasury
Office of Domestic Finance
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds (the "*Study*")

File Number: FR Doc. 2010-25320

Ladies and Gentlemen:

SVB Financial Group ("*SVB*") is pleased to submit these comments in response to the Financial Stability Oversight Council (the "*Council*") Notice and Request for Information on the implementation of the "*Volcker Rule*," as set forth in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "*Dodd-Frank Act*").

We appreciate the opportunity to participate in this process and set out our specific comments in response to the questions below. We urge the Council to make recommendations consistent with these comments to the inter-agency group of regulators that will be issuing regulations to implement the Volcker Rule (collectively, the "*Regulatory Agencies*").

Our comments focus primarily on the core definitions that will determine the scope of the Volcker Rule—specifically, what are "hedge funds" and "private equity funds" within the meaning of this rule? The Volcker Rule was designed to prevent banks from engaging in risky trading activities, whether done directly via proprietary trading or indirectly through funds. We encourage the Council to recommend definitions and regulations that reflect this policy objective. ***In particular, we encourage the Council to recommend that the Regulatory Agencies define the terms "hedge fund" and "private equity fund" in a way that distinguishes them from other types of funds—in particular, venture funds—that were not referred to in the statute, do not pose systemic or safety and soundness risks, and promote and protect the safety and soundness of banking entities and the financial stability of the United States by ensuring the continued flow of capital to high-growth start-ups.*** *(Questions 1(i), 3, 4(iii), 4(iv), 4(xiii), 4(xv) and 7)*

In addition, we encourage the Council to recommend that the Federal Reserve Board (the "*FRB*") promptly clarify (as part of its rulemaking under Section 619(c)(6)) that the Volcker Rule's restrictions on permitted funds apply only to investments made after the Volcker Rule's effective date, and not to pre-existing investments. This reading tracks the language of the statute and is necessary to allow banking entities to effectively seed sponsored funds, pursuant to Section 619(d)(1)(G), if they have substantial pre-existing fund investments. We also request that the FRB clarify that the illiquid funds extension period runs after the conformance period ends. By affirming these readings, the FRB would provide much-needed clarity and certainty to banking organizations during the transition period. *(Questions 1(vii), 3, 4(ix) and 11)*

Finally, we encourage the Council to direct the Regulatory Agencies to clarify how the Volcker Rule applies to funds that invest in other funds, rather than directly in companies (generally referred to as "funds-of-funds"). *(Questions 3 and 6)*

BACKGROUND ON SVB FINANCIAL GROUP

SVB is a bank holding company and a financial holding company. Our principal subsidiary, Silicon Valley Bank, is a California-chartered bank and a member of the Federal Reserve System. As of September 30, 2010, SVB had total assets of $14.75 billion.

We are the premier provider of financial services for companies in the technology, life science, venture capital and premium wine industries. Through Silicon Valley Bank and our other subsidiaries, we provide a comprehensive array of banking services including lending, treasury management, trade finance, foreign exchange and other banking services to our clients worldwide.

We began serving the technology and life science markets in 1983, at a time when these markets were not well understood by the financial services industry, and when many of the leading companies in these industries were just getting started. Over nearly three decades, we have become the most respected bank serving the technology industry and have developed a comprehensive array of banking products and services specifically tailored to meet our clients' needs at every stage of their growth.

Today, we serve more than 13,000 clients through 26 U.S. offices and through international offices located in China, India, Israel and the United Kingdom. We have deep expertise and extensive knowledge of the people and business issues driving the technology sector, which we believe allows us to measurably impact our clients' success.

We earn the vast majority of our income by providing banking and financial services to our clients. In addition to our core banking business, however, SVB (the holding company) also has sponsored venture capital funds, through our SVB Capital division, and made investments in certain third-party venture funds. We conduct our funds business in accordance with applicable law, and use shareholder (not depositor) money for our fund investments. Our regulators, the FRB and the California Department of Financial Institutions, regularly examine our funds business to ensure that it is being conducted in accordance with FRB Regulation Y and all other applicable rules and does not present a risk to SVB or Silicon Valley Bank.

Our sponsored funds, managed by SVB Capital, are predominantly made up of third-party capital. We manage this capital for our fund investors, which include public pensions, foundations and university endowments. We currently manage nine "funds-of-funds" that invest in venture capital funds managed by third parties and four "direct investment funds" that invest directly in high growth technology start-ups. The funds in which our funds-of-funds invest, and the third-party funds in which we invest directly make long-term investments in technology start-up companies.

Our funds are structured as limited partnerships and have a 10 to 13 year life that can be extended to 15 years. Each fund is managed through a general partner, which is a separate subsidiary of SVB. The funds' investors commit to provide a specific amount of capital at the outset of the fund. This capital is then "called" over time, as the fund makes investments.[1] Capital is returned to investors over an extended period, after the underlying portfolio companies are sold or go public. Investors typically cannot redeem or withdraw their commitments absent a regulatory requirement, and are not permitted to transfer their ownership interests without the general partner's consent.

DISCUSSION

I. BANKING ENTITIES SHOULD BE PERMITTED TO INVEST IN AND SPONSOR VENTURE FUNDS *(QUESTIONS 1(I), 3, 4(III), 4(IV), 4(XIII), 4(XV), AND 7)*

A. *The Volcker Rule Applies Only to Hedge and Private Equity Funds – Not to All Privately Offered Funds*

1. *Congress Directed the Regulatory Agencies to Define "Hedge Funds" and "Private Equity Funds"*

The Volcker Rule prohibits banking entities from investing in or sponsoring a "hedge fund or a private equity fund," other than as specifically set forth in the statute.[2] Congress provided guidance as to the legal structure of a "fund," by referencing the Investment Company Act of 1940 (the "*Investment Company Act*"),[3] but gave the Regulatory Agencies the authority and discretion to define the terms "hedge fund" and "private equity fund" and to differentiate them from other types of funds.[4]

Congress did not intend the terms "hedge fund" and "private equity fund" to include all issuers that would be investment companies but for Sections 3(c)(1) or 3(c)(7) of the Investment

---

1 It is customary for funds to call capital over five to seven years. The actual timing of capital calls depends on the investment cycle, overall market conditions, the nature and type of industry in which the underlying portfolio companies operate and other similar factors.

2 Sections 619(a)(1)(B) and 619(d).

3 Section 619(h)(2).

4 As a threshold matter, we believe the terms "hedge fund" and "private equity fund" apply solely to equity funds (*i.e.*, funds that invest or trade in equity securities) and do not apply to debt funds (*i.e.*, funds that lend money or hold loan participations). Lending, whether done directly or through a fund structure, falls squarely within the business activities traditionally performed by banks. There is no policy reason to prohibit bank-permissible lending merely because it is done through a fund structure or to restrict banks from sponsoring or investing in funds that engage in lending activities.

Company Act. Reading the statute otherwise would be flawed for at least three reasons. First, it would fail to give meaning to the specific terms Congress used repeatedly in Section 619—"hedge fund" and "private equity fund." Hedge funds typically make short-term investments in publicly traded securities (including derivatives), incur substantial debt to trade "on margin" and do not have a set fund term, allowing investors to redeem or withdraw their money on short notice. Private equity funds, which are also commonly referred to as leveraged buyout or "LBO" funds, typically use substantial debt (leverage) to take over controlling interests in publicly traded companies, often by buying out existing shareholders and management.

There are a variety of funds that exclusively make other types of investments, including venture capital, energy, and infrastructure funds. These issuers bear no resemblance whatsoever to "hedge funds" or "private equity funds." To read the statute in a way that would sweep all such issuers under the Volcker Rule would ignore Congress' clear and frequent references to two specific types of funds.

Had Congress intended to reach all privately offered funds, it easily could have done so by referring generally to "funds" or "privately offered funds," rather than referring specifically to "hedge funds" and "private equity funds." It did not. In contrast, elsewhere in the Dodd-Frank Act, where Congress intended to reach a broader array of funds, it made its intention clear by using the term "private fund."[5]

The express language of Section 619(h) provides further support that Congress intended the Regulatory Agencies to adopt a more specific definition of "hedge funds" and "private equity funds."[6] When Congress used the disjunctive "or" in the definition ("<u>or</u> such similar fund"), it was indicating that the Regulatory Agencies could—and should—refine the definition as necessary to fit the legislative intent and purpose. The Council and the Regulatory Agencies thus have an obligation to determine an appropriate definition of "hedge funds" and "private equity funds," taking into consideration the common industry meaning of these terms and the purposes of the Volcker Rule.[7]

One can reasonably trace the policy objectives underlying the Volcker Rule (the elimination of bank proprietary trading) to hedge funds and traditional private equity funds that

---

5 *Compare* Title IV of the Act.

6 "The terms 'hedge fund' and 'private equity fund' mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act, <u>or</u> such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine." Section 619(h)(2) (internal citations omitted).

7 *See, e.g.*, Letter from Paul A. Volcker to the Hon. Timothy Geithner (Oct. 29, 2010) ("The plain intent of Section 619 of the Dodd-Frank Act is to restrict certain high risk, proprietary trading activities by banks and bank holding companies, institutions that receive government protection and support. Clear and concise definitions, firmly worded prohibitions, and specificity in describing the permissible activities will be of prime importance for the regulators as they implement and enforce this law. . . . [Any ambiguities within the language of the law] need to be resolved in light of carrying out the basic intent of the law.")

are intertwined with public markets and operate at significant scale. One cannot, however, link the policy objectives of the Volcker Rule to every type of issuer that relies on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act. In fact, doing so would result in a severe disruption to investments in small growing businesses, which create millions of jobs, nurture new inventions and cures for diseases, and significantly contribute to American prosperity and global competitiveness—and without posing any systemic risk to our financial system. Such disruption, in turn, would impair the safety and soundness of banking entities and harm the financial stability of the United States in a manner that the Congress clearly did not intend.[8]

The legislative history confirms this reading of the statute and, in particular, makes clear Congress' intent *not* to define "private equity funds" so broadly as to sweep in venture capital funds. Chairman Dodd, the legislative sponsor for the Volcker Rule, explained it as follows:

> The purpose of the Volcker Rule is to eliminate excessive risk taking activities by banks and their affiliates while at the same time preserving safe, sound investment activities that serve the public interest. It prohibits proprietary trading and limits bank investment in hedge funds and private equity funds for that reason. But properly conducted venture capital investment will not cause the harms at which the Volcker Rule is directed.[9]

Representative Eshoo—a member with a deep understanding of the difference between venture capital and private equity and of the critical role venture funding plays in the innovation economy—was similarly explicit about the Volcker Rule's purpose and scope:

> The purpose of the Volcker Rule is to eliminate risk-taking activities by banks and their affiliates while at the same time preserving safe, sound investment activities that serve the public interest. We have specifically barred bank investment in hedge funds and private equity for that reason.
>
> Venture capital funds do not pose the same risk to the health of the financial system. They promote the public interest by funding growing companies critical to spurring innovation, job creation, and economic competitiveness. The funds typically invest primarily or exclusively in private companies and are significantly smaller.

---

8 Congress recognized the importance of investments in small businesses by allowing banks to continue to invest in small business investment companies under subsection (d)(1)(D). In describing this exemption, Sen. Merkley called small business investment companies "a form of regulated venture capital fund in which banks have a long history of successful participation." 156 Cong. Rec. S5896 (July 15, 2010). In the Boxer-Dodd colloquy, Sen. Boxer noted (and Sen. Dodd confirmed) that the small business investment company exemption in the Volcker Rule was created "because these companies often provide venture capital investment." 156 Cong. Rec. S5904 (July 15, 2010) While the SBIC provision will allow some investments to small businesses to continue, it alone is not sufficient—in particular, because it does not accommodate funds-of-funds, a proven safe, sound, and effective way for banks to invest and sponsor investments in top-tier, high-performing venture funds.

9 156 Cong. Rec. S5904 – S5905 (July 15, 2010).

> 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 and fall outside the definition of "private equity funds."
>
> This clarification will ensure the Dodd-Frank ... Act does not stop venture capital from providing a critical source of capital for startup technology companies.[10]

While not explicitly addressing venture funds, Chairman Frank, in a colloquy with Representative Himes, similarly made explicit that the definition of "hedge fund" and "private equity fund" was not intended to include all issuers that rely on sections 3(c)(1) and 3(c)(7) of the Investment Company Act. Representative Himes queried Chairman Frank:

> I want to confirm that when firms own or control subsidiaries or joint ventures that are used to hold other investments, that the Volcker Rule won't deem those things to be private equity or hedge funds and disrupt the way the firms structure their normal investment holdings.

Chairman Frank responded:

> The point the gentleman makes is absolutely correct. We do not want these overdone. We don't want there to be excessive regulation. And the distinction the gentleman draws is very much in this bill, and we are confident that the regulators will appreciate that distinction, maintain it, and we will be there to make sure that they do.[11]

On the basis of this ample record in the legislative history, and on the plain language of the Volcker Rule, we ask the Council to recommend that the Regulatory Agencies clarify the definitions of "hedge fund" and "private equity fund" in a way that clearly excludes venture capital funds from the restrictions of the Volcker Rule.[12]

---

10 156 Cong. Rec. E1295 (July 13, 2010) (emphasis added).

11 156 Cong. Rec. H5226 (June 30, 2010); *see also* Letter from Rep. Spencer Bachus to Members of the Financial Services Oversight Council (Nov. 3, 2010) at 8 (urging the FSOC and implementing Regulatory Agencies to avoid interpreting the Volcker Rule in an expansive, rigid way that would damage U.S. competitiveness and job creation).

12 The fact that subsection (h)(7) refers to "venture capital *investments*" does not change the analysis. Private equity funds may, at times, make venture capital investments and, as a result, may require the long-term compliance and wind-down periods established in the Volcker Rule for these illiquid investments. The fact that private equity funds may make some venture capital *investments* does not change the fact that venture capital *funds* are fundamentally different from private equity *funds*.

2. *Venture Funds Are Fundamentally Different from Private Equity Funds*

Congress recognized that venture capital funds are different from private equity funds in Title IV of the Dodd-Frank Act, where it excluded venture capital fund advisers from certain registration requirements under the Investment Advisers Act of 1940 and directed the Securities and Exchange Commission to define venture capital.

As discussed in Sections I.C.1 and I.C.2 below, venture capital as a *sector* is distinct from private equity as a *sector*—perhaps most importantly in terms of the sector's total size, and, secondarily, in terms of the active role venture investors play in nurturing start-ups and high growth companies.

Venture capital *funds*, moreover, can be distinguished from private equity/buyout *funds* in several important respects. The most pertinent distinctions include the following:

- *Long-term investment horizon:* Venture funds typically have a term of ten or more years, which allows them to nurture start-ups until they grow to the point that those companies can access public equity markets through an initial public offering ("*IPO*") or are purchased by another company. Investors in venture funds make long-term commitments, during a fixed fundraising period, to fund a fixed dollar amount over a set period of time. Additionally, investors in venture capital funds are not allowed to redeem or withdraw their commitments, absent extraordinary circumstances (*e.g.*, regulatory requirements). Similarly, venture funds make long-term investments in their underlying portfolio companies, often providing successive rounds of capital to fund different stages of a company's growth.

- *Limited use of leverage:* Venture funds rarely use debt. When used, debt is typically short term (less than 180 days) and is used to fund investments while the fund calls capital from its limited partners. Underlying portfolio companies also typically use limited leverage, although specific rates vary by sector. For example, capital-intensive clean energy companies typically use more debt than capital-efficient software or internet companies. Finally, the debt incurred by a venture fund portfolio company is typically for operating expenses or capital expenditures, not to financially engineer the fund's acquisition of the company or to allow the fund to take profits out of the company in the form of dividends.[13]

- *Investments in private companies:* Venture funds invest the majority of their capital in securities issued by privately held companies, not in derivatives or commodities and typically not in publicly traded companies. Therefore, they are not dependent on or subject to the volatility of public markets.

- *Minority investments in collaboration with entrepreneurs:* Venture funds typically, over time, hold minority positions in the companies they fund. As discussed in Section I.C.1

[13] Venture-backed companies' limited use of leverage is part of the venture business model. *See* SVB Capital, Venture Investing is Less Risky Than You Think (Aug. 2010) [*hereinafter* Venture is Less Risky] at 9.

below, they grow their portfolio companies alongside management, working side-by-side with entrepreneurs to help with strategy, sales and marketing, team recruiting, and other resources that seek to complement the "sweat equity" that entrepreneurs contribute.

In sum, venture capital is distinct from private equity/buyout and should be treated as such for purposes of the Volcker Rule.

B. *Venture Funds Should Be Treated as "Permitted Activities" per Section 619(d)(1)(J)*

Even if the Council decides against recommending that venture funds fall outside the definitions of "hedge" and "private equity" funds, it should recommend that the Regulatory Agencies adopt rules permitting banks to continue to sponsor and invest in venture funds pursuant to Section 619(d)(1)(J) of the Volcker Rule. That section grants the Regulatory Agencies broad authority to permit activities that promote and protect the safety and soundness of banking entities and the financial stability of the United States.

1. *Congress Directed the Regulatory Agencies to Exclude Venture Funds Under Section 619(d)(1)(J)*

Senators Dodd and Boxer made clear that, while venture funds generally should not be included in the definition of "hedge fund" and "private equity fund," to the extent that the definition catches some venture capital funds, the Regulatory Agencies have ample discretion under subsection (d)(1)(J)—and should use that discretion—to exempt these investments from the Volcker Rule.

> Mrs. BOXER. Mr. President, I wish to ask my good friend, the Senator from Connecticut and the chairman of the Banking Committee, to engage in a brief discussion relating to the final Volcker rule and the role of venture capital in creating jobs and growing companies.
>
> I strongly support the Dodd-Frank Wall Street Reform and Consumer Protection Act, including a strong and effective Volcker rule, which is found in Section 619 of the legislation.
>
> I know the chairman recognizes, as we all do, the crucial and unique role that venture capital plays in spurring innovation, creating jobs and growing companies. <u>I also know the authors of this bill do not intend the Volcker rule to cut off sources of capital for America's technology startups, particularly in this difficult economy</u>. Section 619 explicitly exempts small business investment companies from the rule, and because these companies often provide venture capital investment, <u>I believe the intent of the rule is not to harm venture capital investment</u>.
>
> Is my understanding correct?

> Mr. DODD. Mr. President, I thank my friend, the Senator from California, for her support and for all the work we have done together on this important issue. Her 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 and fall outside the definition of "private equity funds". This clarification will ensure the Dodd-Frank Wall Street Reform and Consumer Protection Act does not stop venture capital from providing a critical source of capital for startup technology companies. In the event that properly conducted venture capital investment is excessively restricted by the provisions of section 619, I would expect the appropriate Federal regulators to exempt it using their authority under section 619(d)(1)(J).[14]

Senator Brown—who played an active role in developing and refining the Volcker Rule—also endorsed the use of Section 619(d)(1)(J) exemptive authority when he stated:

> One other area of remaining uncertainty that has been left to the regulators is the treatment of bank investments in venture capital funds. Regulators should carefully consider whether banks that focus overwhelmingly on lending to and investing in startup technology companies should be captured by one-size-fits-all restrictions under the Volcker rule. I believe they should not be. 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.[15]

2. *Venture Capital Investing Promotes Banking Safety and Soundness Risks and Reduces Conflicts of Interests*

Venture capital investments also meet the statutory test set forth in Section 619(d)(1)(J), in that they promote the financial stability of the United States as a whole (which we discuss in detail in the next section) and enhance the safety and soundness of banking entities.[16]

---

[14] 156 Cong. Rec. S5904 – S5905 (July 15, 2010) (emphasis added).

[15] 156 Cong. Rec. S6242 (July 26, 2010). Senator Brown also noted the truncated legislative process that the Volcker Rule followed and the detrimental effect this truncated process had on the clarity with which some provisions were drafted. *Id.* at S6241.

[16] The relevant Regulatory Agencies have the rulemaking authority under subsection (d)(2) and (d)(3) to impose additional restrictions, including additional capital requirements, with respect to permitted activities, including those activities permitted under subsection (d)(1)(J). For the reasons discussed in this Section I.B.2, we believe that investing in venture funds does not result in any material conflicts of interest and, instead, promotes the safety and soundness of banking entities. We do not believe it is necessary or appropriate to impose additional restrictions or requirements. If individual practices at individual banking entities raise concerns, the Regulatory Agencies should address these issues using their supervisory authorities and do so on a case-by-case basis. Furthermore, we believe that an exemption provided under subsection (d)(1)(J) should extend to all of the restrictions of the Volcker Rule, including the *de minimis* investment limitations provided for in subsection (d)(4).

By investing in and sponsoring venture capital funds, banks that work with technology companies can deepen their knowledge of the sectors they serve and the trends affecting their clients, as well as diversify their revenues. Venture capital funds predominantly make equity investments in private companies in specific sectors, which have different risk-return correlations than other traditional bank activities. Furthermore, by investing in a fund-of-fund structure, a banking entity is able to diversify among more underlying investments and also among more asset managers.

The lack of leverage—noted above as one distinguishing characteristic of venture funds—further limits safety and soundness risks. Were a fund to lose capital (a rare event, as discussed in the following paragraph), at worst a dollar lost would be a dollar lost.[17] Without leverage, there is no risk of the kind of cascading effect we saw during the financial crisis, in which what appeared at face value to be manageable risks were transformed into massive losses through leverage.

Venture capital funds have a long track record of being safe and profitable investments for banking entities. When public markets are healthy, venture capital firms have median internal rates of return of 20 to 40%.[18] Over the 25-year period from 1980-2005, 85% of venture funds returned invested capital plus gains to investors, while fewer than 10% of funds lost 50% or more of their invested capital.[19] Even during what was likely the worst investing period in the history of venture (2000-2002), SVB Capital projects that its fund investments should distribute 1.05 to 1.17 times the amount of capital paid in, with a most likely final outcome of 1.11x distributions to paid-in capital.[20] We are aware of no case in which a banking organization has had to step in to cover losses in a venture fund.

Venture investing also is not interconnected into the broader financial market, further limiting safety and soundness risks. Investments are made in private companies; fund interests generally are not redeemable during the fund's life (and funds thus do not act as a source of liquidity for other parties); and investments are made with cash and do not employ complicated multi-party financial instruments. As a result, each bank's exposure can be assessed on a stand-alone basis, thus avoiding one of the supervision challenges experienced during the downturn.

In addition, compensation structures for venture funds are well aligned with sound risk management practices. Funds make distributions to limited partners, and the general partner earns carried interest, only over the long term, when companies are sold or taken public. Gains, thus, are real and realized—not speculative, short term, or subject to volatile ups and downs.

---

17 SVB Capital analysis using Preqin Performance Analyst data.

18 Venture is Less Risky, *supra* note 13, at 1 (citing Cambridge Associates LLC, Dow Jones & Company, Inc., Standard & Poor's and Thomson Datastream).

19 SVB Capital analysis using Preqin Performance Analyst data.

20 Venture is Less Risky, *supra* note 13, at 3. The 1.05 – 1.17x range represents the range of outcomes at a 90% probability. All outcomes are net of carried interest and management fees.

Finally, *any* permitted venture fund activities conducted by a bank entity would, of course, remain subject to ongoing safety and soundness regulation.[21] Existing laws and regulations—many of which have been enhanced by the Dodd-Frank Act, separate and apart from the Volcker Rule—provide regulators with ample authority to oversee banking entity activity and to prohibit investments, fund sponsorships or other actions that present a safety and soundness risk to a financial institution.

The current structure for making and supervising investments in venture funds not only advances safety and soundness goals, it is far preferable from the perspective of avoiding conflicts of interest. When banks invest in the funds they sponsor, they increase their alignment with their investors, reduce the risks of conflicts of interest, and promote their long-term commitment to creating strong, stable investment funds. In fact, venture capital general partners and limited partners have long believed that it is essential for general partners to invest in their funds in order to align their interests with those of their limited partners.[22]

C. *Permitting Banks to Sponsor and Invest in Venture Funds Is Consistent with the Volcker Rule's Purposes and Serves Important Public Policy Objectives*

1. *Venture Investments Promote U.S. Job Creation, Economic Competitiveness and Financial Stability*

Venture capital meets the statutory test of Section 619(d)(1)(J) by promoting the financial stability and growth of the U.S. economy. To begin, venture capital's importance to the economy stems from the unique role it plays in backing high-growth technology companies—companies that create jobs, drive economic growth, give rise to entire new sectors of the U.S. and global economies, and transform how Americans live and work.

---

21 Through these ongoing reviews, the Regulatory Agencies could ensure that banking entities comply with the letter and spirit of the definitions of "hedge fund" and "private equity fund" and oversee the safety and soundness of the activities. Unlike in the case of proprietary trading, in which a bank's strategy, risk management and overall risk profile can change on a moment-by-moment (or person-by-person) basis, investing in and sponsoring venture funds is a slow, steady process involving several months of fundraising, several years of making initial investments, and a decade or more managing a finite portfolio of long-term investments, and thus can be overseen effectively through normal supervision and examination processes.

22 Many of those who have studied the financial crisis have noted the perverse effect that over-reliance on transaction fees, rather than activities that create true economic value, has had on the financial services sector. If banks were allowed to sponsor venture funds, but were not allowed to invest in those funds, they would have an incentive to drive up fund sizes as a way to earn more management fees. This would not be good for the venture sector as a whole, or for investors in bank-sponsored funds. A system in which banks invest reasonable amounts of capital alongside their outside investors ensures they remain committed to the performance of the fund and the success of the underlying portfolio companies. While this may also be true for private equity funds, there are two distinctions worth drawing. One, because venture funds do not present safety and soundness risks, regulators do not need to mitigate those risks by limiting investments. And second, the venture sector has less capacity to absorb inflated investment levels than the private equity sector due to its small size and the nature of investing in start-ups.

Some statistics make this point clear. According to the leading study of the impact of venture capital-backed companies on the U.S. economy:

- <u>*Venture investments yield outsized returns to the U.S. economy*</u>. As of 2008 (the last year for which data has been made available), companies that were or had been venture-backed ***employed more than 12 million people*** and generated nearly ***$3 trillion in revenues***—or, in other words, represented ***11% of private sector employment*** and the equivalent of ***21% of U.S. GDP.*** This is particularly noteworthy when one considers the fact that venture *investments* equal roughly 0.2% of U.S. GDP. The venture sector, thus, returns to U.S. GDP 100 times the amount of the original investment.[23] Even in the current economy, with unemployment running at a 9.6%, venture firms are creating thousands of new jobs, as evidenced on the website Startuphire.com.[24]

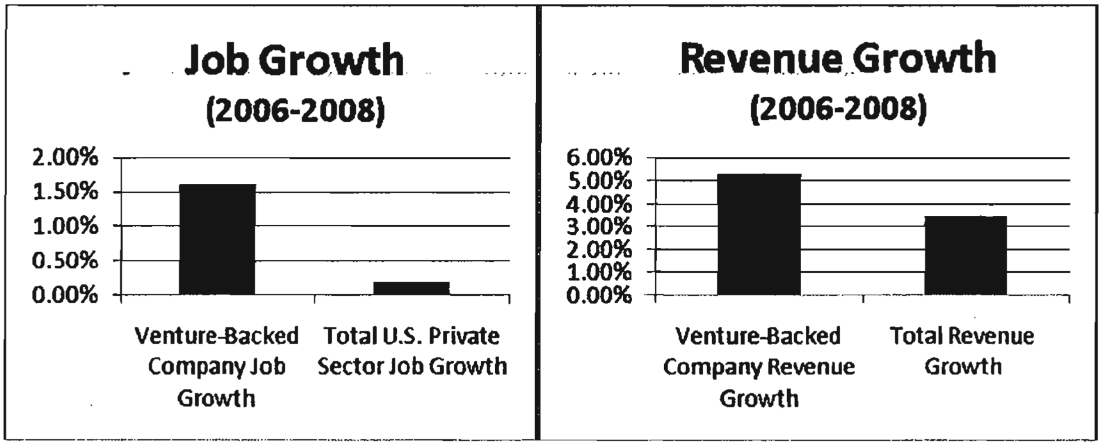
- <u>*Venture-backed companies outperform the broader economy*</u>. Venture-backed companies outperformed the overall economy in terms of creating jobs and growing revenues, as illustrated in the following charts.[25]

---

23 National Venture Capital Association, NVCA Yearbook 2010 (Mar. 2010) [*hereinafter* 2010 NVCA Yearbook] at 7; J. Haltiwanger, R. Jarmin and J. Miranda, *Who Creates Jobs? Small vs. Large vs. Young*, NBER Working Paper No. 16300 (Aug. 2010). *See also* L. Klapper & I. Love, *The Impact of the Financial Crisis on New Firm Registration,* Policy Research Working Paper 5444, The World Bank Development Research Group, Finance and Private Sector Development Team at 1 (Oct. 2010), at 3 (concluding that <u>young</u> firms – not small firms, as is commonly believed – are the principal force behind both gross and net new job creation); *id.* at 1 ("Entrepreneurship is essential for the continued dynamism of the modern market economy and a robust entry rate of new businesses can foster competition and economic growth. Entrepreneurial activity can also contribute to employment generation.")

24 Currently, there are postings by more than 475 venture firms listing more than 18,000 job openings in venture-backed companies.

25 IHS Global Insight, Venture Impact: The Economic Importance of Venture-Capital Backed Companies to the U.S. Economy (5th Ed.) (2009) [*hereinafter*, Venture Impact] at 8. In addition, according to a recent analysis of nearly 800 Silicon Valley Bank portfolio companies in the hardware and software sectors, the technology sector showed a pronounced uptick in second quarter sales growth, bucking macro-economic trends. While overall GDP declined during the quarter and showed flat growth year-over-year, the technology sector saw positive sales growth year-over-year and in Q2 2010.



- _Venture investments create new, long-lasting companies and industries_. The venture-backed innovation sector has created new industries—from information technology, biotechnology, semiconductors, and online-retailing to emerging industries such as clean technology, social media, and cloud computing. To give a sense for the long-lasting impact of the venture ecosystem on the U.S. economy, as of 2008, eight out of ten people employed in the software development industry worked for a company with venture capital roots; seven out of ten people employed in the telecommunications and semiconductor industries worked for a company with venture capital roots; and more than half of the people employed in the network and equipment and electronics/instrumentation industries worked for a company with venture capital roots. Venture-backed companies include a long list of household names—from Apple, Google, Amazon, Cisco, Oracle, Home Depot and Staples to Starbucks, eBay, Whole Foods Market, Genentech, Amgen, Intel, Microsoft, JetBlue and FedEx—that have transformed the way Americans live and work.

The venture-backed innovation sector contributes to U.S. economic vitality and financial stability in ways that go far beyond start-ups' direct impact on jobs and GDP growth. As summarized in a recent report issued by the Information Technology & Innovation Foundation, innovation leads to broader job growth in three ways: by giving U.S. firms a "first mover" advantage and, thus, expanding exports and employment; by creating a "virtuous cycle" of expanding employment; and by increasing productivity and, thereby, leading to increased wages and lower prices (which in turn further expand economic activity and create jobs).[26] Innovation helps move our economy forward, to one characterized by a mix of highly productive and innovative industries.[27] It helps create a pipeline of new ideas and new products that enable larger, more mature firms to continue growing. And, finally, innovation plays a central role in improving citizens' quality of life by expanding access to information, providing higher quality

---

[26] R. Atkinson et al., The Information Technology & Innovation Foundation, Innovation Policy on a Budget: Driving Innovation in a Time of Fiscal Constraint (Sept. 24, 2010) at 2 [*hereinafter* "ITIF Innovation Policy"].

[27] *Id.*

goods and services, improving health care quality and access, and fostering a more sustainable environment.[28]

One can see the effects venture-backed companies have on the American landscape by examining the health care sector. Experts agree that virtually the entire biotechnology industry and most of the significant breakthroughs in the medical devices industry would not exist without the support of the venture capital industry.[29] Over the past 20 years, venture funds have invested tens of billions of dollars in thousands of companies with new ideas.[30] The results have reshaped our economy and our lives. As of 2006, nine formerly venture-backed companies alone employed more than 75,000 people and accounted for over $40 *billion* in revenues.[31] In total, in that year, venture financed life science companies supported 493,800 jobs and generated $132 *billion* in revenues.[32] Equally importantly, these companies serve as the R&D pipeline for larger life sciences companies looking for innovation. Over the five year period preceding the study, close to 200 venture-backed life sciences companies were acquired by more mature health care companies for their innovations.[33] Furthermore, venture-backed innovations have changed health care for all Americans: more than one in three Americans (or 100 million individuals) have been positively affected by innovations that were developed and launched by a venture-backed life sciences company during the past 20 years.[34]

Venture-backed companies thus have broad, deep, and positive direct and indirect effects on the U.S. economy, on individual Americans, and on the creation of highly skilled, high paying jobs.[35]

---

[28] *Id.* at 3.

[29] National Venture Capital Association, Patient Capital: How Venture Capital Investment Drives Revolutionary Medical Innovation (2007) at 3 [*hereinafter* "Patient Capital"].

[30] *Id.* at 5.

[31] *Id.* at 2.

[32] *Id.* at 3.

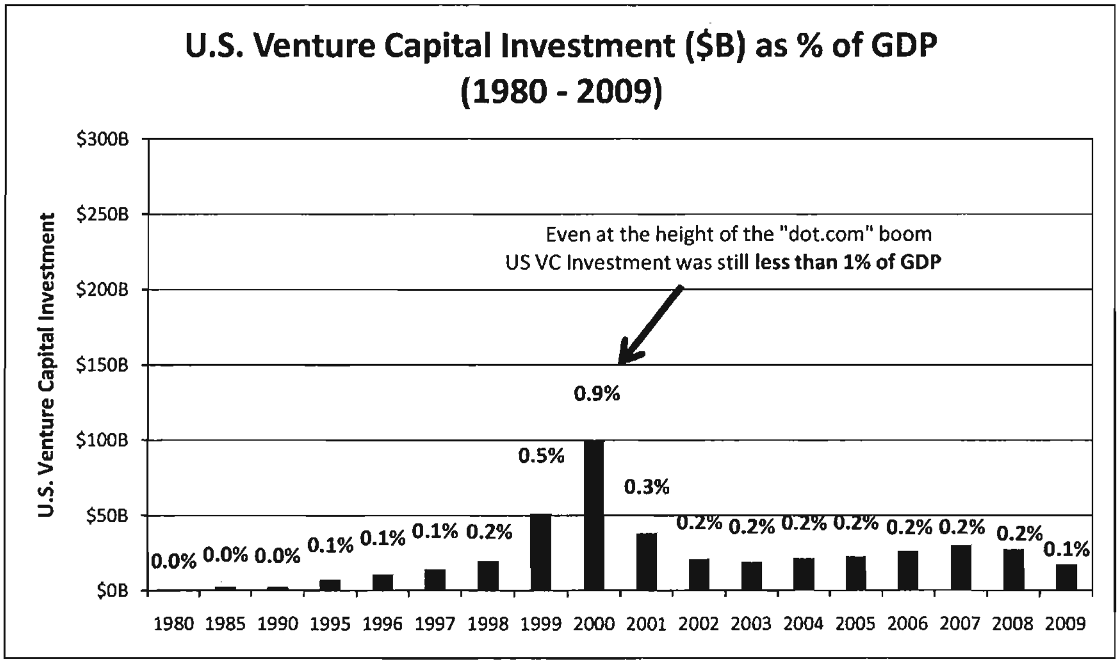
[33] *Id.* at 4.

[34] For example, Magnetic Resonance Imaging (MRI) and ultrasound diagnostic imaging have virtually eliminated exploratory surgery for countless conditions. *Id.* at 4. Other venture-backed breakthroughs include implantable defibrillators, spinal implants, glucose self-monitoring devices for diabetes, and pulse oximetry. *Id.* at 4; *see also id.* at 10 (listing innovative treatment examples from venture backed medical start-ups in the areas of heart disease, cancer, stroke, respiratory disease, diabetes and spinal injuries).

[35] *See* ITIF Innovation Policy, *supra* note 26, at 2 ("Highly innovative economies are characterized by a diverse mix of high-paying, capital-intense, productive industries, while less dynamic economies tend to focus on a handful of commodity-driven industries that are low-wage and concentrated in lower portions of the value chain.").

2. *Venture Capital Is Not Systemically Risky*

While venture investments have an outsized impact on the U.S. economy, the total dollars invested via venture capital funds represent an extremely small portion of the U.S. financial services sector and the U.S. economy.



Source: PricewaterhouseCoopers/National Venture Capital Association MoneyTree™ Report based on data from Thomson Reuters

In 2009, the total amount of venture capital investment was $18 billion, or roughly 0.1% of the U.S. GDP.[36] As seen in the chart above, on an annual basis, the total annual amount invested across the venture sector has ranged from roughly $20 billion to roughly $40 billion over the past decade.[37] Even at the height of the "dot.com" boom, annual venture investment peaked at just over $100 billion and in 2009 total venture capital under management was $179 billion.[38] Hedge funds, in contrast, managed roughly $1.5 trillion as of the first quarter of 2010.[39]

---

[36] 2010 NVCA Yearbook, *supra* note 23, at 11; and U.S. Bureau of Economic Analysis.

[37] PricewaterhouseCoopers/National Venture Capital Association MoneyTree™ Report based on data from Thomson Reuters.

[38] 2010 NVCA Yearbook, *supra* note 23, at 9.

[39] Todd Groome, *Regulation: Tackling Systemic Risk*, AIMA Journal (Q1 2010) at 16.

To place the scale of venture investing in context, in the year and a half leading up to the financial crisis, one firm—Lehman Brothers—lost more than $32 billion from proprietary trading and principal transactions. Another—Merrill Lynch—lost nearly $20 billion on investments in collateralized debt obligations.[40] Morgan Stanley suffered nearly $4 billion in proprietary trading losses in a single quarter; Goldman Sachs spent nearly $3 billion to bail out one of its hedge funds; and Citigroup poured more than $3 billion into fixing problems with its sponsored structured investment vehicles.[41] In other words, during the financial crisis, large banking organizations lost amounts that were roughly comparable in size to the entire amount of venture capital invested by all firms across the entire U.S. economy. Or said another way, in order for the venture sector *as a whole* to lose the amount a *single one* of these large banks lost through proprietary trading and related activities, thousands of individual businesses, in different industries and at different stages of their life cycle, located across the United States, would have to simultaneously and suddenly fail.[42]

The limited scale of venture is not a random outcome and, importantly for purposes of determining its potential to present systemic risks, is not susceptible to change. Venture is fundamentally unlike most other investment classes due to natural "supply" and "demand" inhibitors. Core to venture capital is innovation and the company building skills of its investors.

On the "supply" side, venture capitalists provide more than just money. Typically, venture funds bring together a small number of individuals with complementary skills in building businesses.[43] Many have already had successful careers as entrepreneurs, scientists, engineers, or doctors. These professionals typically review hundreds of business cases in order to select a small handful of companies in which to invest.[44] They then play an active, hands-on role in those companies. Venture investors typically sit on their portfolio companies' boards and work actively with a company's management to develop the business strategy, build the management team, guide the company through subsequent financing rounds, and help transform the business from concept to commercialization. In addition, venture capital fund managers typically invest meaningful sums of their own money in the funds they manage and tie their compensation to the long-term success of the companies they nurture. These attributes naturally limit the number of individuals with the skills, experience, and patience to act as venture fund managers, as well as the number of investments those individuals realistically can make.

40 Stephen Gandel, *Is Proprietary Trading too Wild for Wall Street?*, Time (Feb. 5, 2010).

41 *Id.*

42 Venture capital firms spread their investments across 3,276 companies in 2008, 3,312 companies in 2007, 3,095 companies in 2006, 2,709 companies in 2005, 2,627 companies in 2004, 2,462 in 2003, 2,638 in 2002, 3,787 in 2001, and 6,335 in 2000. Venture Impact, *supra* note 25, at 10.

43 In 2009, the average venture firm consisted of nine investing professionals, and the total number of venture firms nationwide was 794. 2010 NVCA Yearbook, *supra* note 23, at 9.

44 The "Venture Impact" study estimates that, for every investment a venture fund makes, it typically has reviewed 100 business plans and subjected ten of those plans to due diligence. Venture Impact, *supra* note 25, at 4.

On the "demand" side, venture funds make long-term investments in private companies—or, in other words, venture investment can occur *only* when there is an entrepreneur, with a fundable idea, who is seeking capital. The typical duration of venture investments is five to ten years—unlike funds that trade in public securities (often with hold periods of hours, minutes, seconds, or less). As a result, there are a finite number of opportunities, and the opportunities that exist cannot be magnified through short term "churn" trading.

Venture capital investing has a number of other attributes that prevent it from creating systemic risk. The venture sector is not interconnected with the broader financial system. Funds are structured as very long term investment vehicles, and venture investors cannot redeem their interests prior to the fund's end date. Neither investors nor fund managers receive returns (whether distributions to investors, or carried interest to the general partner) until individual companies within the venture fund's portfolio are sold or go public. Investments typically are made in private companies—not publicly traded securities.

Venture funds and their portfolio companies typically use very limited leverage; thus, there is no "cascading effect" even if an individual company fails, or even if an entire fund failed to return invested capital—for an investor, the total amount that can be lost is capped at the amount of the investment.[45] Venture funds, moreover, do not have counter-party obligations—they use cash to fund equity investments, and do not rely on complex financial instruments.

3. *Banking Entities Are an Important Source of Capital for Start-up Companies*

Of course, implementation of the Volcker Rule will only have a meaningful impact on the innovation ecosystem if banking entities play a meaningful role in that ecosystem. They do.

First, banks account for at least 7% of the total capital invested in venture capital funds and represent the sixth largest investor class in the sector.[46] Prohibiting banking entities from sponsoring and investing in venture capital funds thus would measurably depress total capital flowing to venture funds and, through venture funds, into innovative high growth companies. To extrapolate from the data cited above on the 1:100 relationship between venture investing and U.S. GDP from venture-backed companies, assuming banks account for approximately $2 billion in annual venture investing (7% of roughly $30 billion), removing bank capital from the

45 We note that venture debt funds also exist. These funds are structured in a manner that is similar to venture capital funds, but they provide debt (rather than make equity investments) in portfolio companies. As with bank debt, venture debt typically is used to meet capital and operating needs of the business and companies use only limited leverage.

46 Preqin Ltd., The Venture Capital Industry: A Preqin Special Report (Oct. 2010) [*hereinafter* Venture Capital Industry] at 9. We note that these figures almost surely underestimate the impact of banking entities (as defined in the Volcker Rule) exiting this industry, since these figures are taken from a study that distinguishes banks from other investors, such as insurers and asset managers, that also may be subject to the Volcker Rule. In fact, many insurers and asset managers are likely to be treated as banking entities for purposes of the Volcker Rule, since they are often affiliated with insured depository institutions.

investment cycle could have a long-term negative effect on U.S. GDP of roughly $200 billion annually.

Second, removing bank capital from the venture sector would exacerbate other trends in the venture sector and amplify existing challenges in ensuring adequate capital flows to start-ups. Over the last several years, the total amount raised by venture capital funds has declined significantly. In 2009, $16.5 billion was raised, which is just over half the amount raised in 2008. The decline continued in the first three quarters of 2010—the amount raised was approximately one-third the amount raised in 2008.[47]

Third, this downward pressure comes at a time that start-ups are moving into capital intensive sectors, particularly clean energy and other clean technologies. Energy innovation takes enormous amounts of capital—to develop entirely new ways of creating energy, in the case of bio-fuels; to build new manufacturing facilities, in the case of solar energy and electric vehicles; to build new infrastructure, in the case of smart grid and electric transportation systems; or to deploy alternative energy systems, in the case of wind, solar and storage—to name just a few examples. Despite these challenges, the venture sector has taken up the charge. Since 2006, annual venture investment in the clean technology sector has been in the billions, peaking at over $4 billion and representing 14% of all venture investment in 2008. As overall venture investing has declined, so has clean technology investment—it dropped to $2 billion in 2009, but still represented over 10% of all venture investment.[48] However, most investors expect investment levels to rise in the next five years.[49] For the United States, it is critical entrepreneurs get the capital they need—whether one looks at national security, global competitiveness, economic growth or addressing climate change, alternative energy development and deployment is a national priority. As President Obama said:

> Each of us has a part to play in a new future that will benefit all of us. As we recover from this recession, the transition to clean energy has the potential to grow our economy and create millions of jobs—but only if we accelerate that transition. Only if we seize the moment. And only if we rally together and act as one nation—workers and entrepreneurs; scientists and citizens; the public and private sectors.[50]

---

[47] Venture capital funds raised $9.1 billion in the first three quarters of 2010. This was down from annual fund-raising of $16.5 billion in 2009, $28.5 billion in 2008, and $35.4 billion in 2007. Thomson Reuters and National Venture Capital Association Press Release (Oct. 11, 2010) at 1.

[48] Venture capital investment in clean technology was $1.6 billion in 2006, $2.6 billion in 2007, $4.0 billion in 2008, and $2.1B in 2009. PricewaterhouseCoopers/National Venture Capital Association MoneyTree™ Report, Data: Thomson Reuters.

[49] Deloitte and Touche LLP, 2010 Global Trends in Venture Capital: Outlook for the Future (July 28, 2010) [*hereinafter* Deloitte Survey].

[50] Issues: Energy & Environment, Whitehouse.gov (last accessed Nov. 1, 2010) (quoting Pres. Obama on June 15, 2010), *available at* http://www.whitehouse.gov/issues/energy-and-environment.

Eliminating the source of nearly one-tenth of the capital needed to sustain and nurture these companies flies in the face of the kinds of policy choices the President has advocated. Doing it where Congress not only did not require it, but affirmatively gave the Regulatory Agencies the flexibility to avoid this perverse outcome, would be truly counter-productive.[51]

4. *Bad Policy Choices Can Hurt the Innovation Ecosystem*

An overly restrictive reading of the Volcker Rule would represent one more damaging step in a long series of damaging steps that, together, are having a clear, negative impact on the U.S. innovation sector and U.S. competitiveness.

As a nation, we have long had the luxury of thinking of ourselves as a leader in innovation and economic competitiveness. Yet in a striking recent finding, the European-American Business Council and the Information Technology & Innovation Foundation found that the United States ranks sixth overall among the 40 nations and regions studied in terms of innovation and competitiveness—in brief, we are not the runaway leader in global competitiveness that some believe.[52] In an even more troubling finding, the study found that *every single one* of the 39 other countries and regions studied made more, faster progress in improving their innovation capacity and international competitiveness over the past decade than the United States.[53]

One indicator of the health of the U.S. innovation sector is the level of IPOs by U.S. companies on U.S. stock exchanges. The first six months of 2009 represented the worst IPO market in 40 years.[54] Given that the size of the U.S. economy, in real GDP terms, is over three times what it was 40 years ago, this is a remarkable and frightening state of affairs. In significant part, this is a by-product of a number of legal, policy, and market changes that have made it more difficult for companies to go public and increased meaningfully the size at which they can realistically contemplate a public offering.[55]

---

51 Notably, one of the United States' leading partners is heading in exactly the opposite direction, recognizing the beneficial role banks can play in providing safe, long-term sources of capital to the venture sector. Just weeks ago, Britain's six largest banks announced that—in a project overseen by the British Bankers' Association in conjunction with the U.K. Treasury and the U.K. Department of Business—they will pledge around £1 billion into a new venture capital fund designed to capitalize smaller business. Paul Thomas, *Banks Set Up Venture Capital Fund for Small Businesses*, Money Marketing (Oct. 5, 2010); Iain Laing, *Banks Plan Venture Capital Fund*, nebusiness.co.uk (Oct. 6, 2010), *available at* http://www.nebusiness.co.uk/business-news/latest-business-news/2010/10/06/banks-plan-venture-capital-fund-51140-27409602/.

52 European-American Business Council/The Information Technology & Innovation Foundation (ITIF), The Atlantic Century: Benchmarking EU & U.S. Innovation and Competitiveness (Feb. 2009) at 1.

53 *Id.*

54 Only 12 companies went public in the United States in the first half of 2009, and only eight of them were U.S. companies.

55 The median IPO in the first half of 2009 was $135 million in size. This contrasts to 20 years ago, when it was common for Wall Street to do $10 million IPOs and have them succeed. Although the IPO market has

The financial crisis has compounded the risks facing economies such as ours. In a recent study, researchers at the World Bank assessed the impact the financial crisis had on new company formation and reached several important conclusions: Dynamic business creation occurs in countries that provide entrepreneurs with reduced red tape and a stable investment climate; regulatory policies and access to capital are among the handful of factors that most strongly influence the level of new business formation; and, during the financial crisis, new business creation slowed and countries with more developed financial markets experienced larger contractions in new firm creation, most likely due to problems accessing capital.[56]

Investment trends further illustrate the negative trend line. Venture investing historically has been a uniquely U.S. phenomenon, and today, roughly half of all venture firms are located in North America.[57] But over the past decade, both entrepreneurs and investors have shifted their focus and begun to build robust innovation sectors in markets around the globe. In 2000, North American-focused funds raised 75% of the total capital raised by venture firms, yet by 2008, funds focused on Asia and the rest of the world were raising 37% of the total.[58] According to a recent annual survey of investing professionals conducted by Deloitte:

- Investing professionals expect the venture industry to contract in the United States and Europe and to grow in emerging markets, including China, India and Brazil – whether measured in the number of firms investing or the number of dollars invested.[59]

---

improved in 2010, IPOs and, therefore, jobs and GDP growth continue to suffer from changes in the brokerage markets and regulatory landscape. The establishment of online brokerages, decimalization, the Manning Rule, the Order Handling Rules and the Gramm-Leach-Bliley Act all contributed to lower numbers of IPOs of venture-backed companies. *See, e.g.*, D. Weild and E. Kim, Grant Thornton, Market Structure is Causing the IPO Crisis (June 2010).

56 Klapper & Love, *supra* note 23, at 2-3, 20-21, 22. Specific regulatory factors included starting costs (official fees and other costs of incorporating a business), number of procedures necessary to incorporate a business, time required to incorporate and start a business, political stability, government effectiveness, regulatory quality, rule of law, control of corruption, and corporate governance. *Id.* at 10-11. While the study focuses specifically on debt (rather than equity), its conclusions about the impact on new business formation of sharp declines in available funding would appear to apply to both forms of capital. *Id.* at 20-21.

57 Venture Capital Industry, *supra* note 46, at 3.

58 *Id.*

59 A startling 92% expect the number of venture firms in the United States will decrease moderately or significantly and 72% expect investments in the United States will decrease moderately or significantly. Deloitte Survey, *supra* note 49. 99% expect the number of venture firms in China will *increase* significantly or moderately, while 98% make this prediction for Brazil and 86% make this prediction for India. 70% of all respondents expect dollars invested in China will *increase* significantly, 51% make this prediction for Brazil and 41% make this prediction for India. Equally startlingly, every respondent predicted that, at worst, investments in China and Brazil will increase at least moderately, and virtually all (91%) made this prediction for India. *Id.*

- The institutions that invest in venture funds (typically, endowments, pension funds, and foundations) expect to shift larger allocations to emerging markets over the coming five years.[60]

- The respondents see a direct correlation between current trends in venture investing and the long-term dominance of the United States in the technology sector.[61]

- They also see an important and growing link between government policies and the strength of the venture and entrepreneurial sectors—for good, and for bad.[62]

The above data illustrates two critically important points. One, an economy that can promote a thriving innovation sector—including a thriving venture capital sector—can achieve very significant benefits in terms of economic vibrancy, job and GDP growth, international competitiveness and technological leadership. Two, innovation will occur—the only question is where. If we want to ensure that the United States retains its position at the center of innovation, U.S. policymakers should take extreme care before imposing new restrictions that artificially restrict the flow of capital into this vital sector.[63]

II. THE FRB SHOULD PROMPTLY CLARIFY THAT (A) THE ILLIQUID FUNDS EXTENSION RUNS AFTER THE END OF THE CONFORMANCE PERIOD AND (B) SECTION 619(D)'S LIMITS ON PERMITTED INVESTMENTS DO NOT APPLY TO INVESTMENTS MADE PRIOR TO THE VOLCKER RULE'S EFFECTIVE DATE (*QUESTIONS 1(VII), 3, 4(IX), AND 11*)

Several of the questions posed by the Council ask about the time periods for banking entities to divest illiquid assets and, more generally, about the timing of the application of the Volcker Rule's restrictions.

Banking entities need clear guidance as soon as possible from the FRB about how the transition periods will operate and what restrictions will apply during such periods. This guidance needs, among other points, to make clear that the caps and limits in Section 619(d) of the Volcker Rule only apply to new investments, conducted per the requirements of the Volcker Rule, and not to pre-existing investments, made prior to the effective date of the rule. Failure to make this point clearly in the FRB's conformance period rules could significantly affect the

---

60 Only 15% of limited partners are more inclined to invest in the United States, while 56% are less inclined to do so. *Id.*

61 While 36% think the United States will remain a dominant force, 42% see this as only "somewhat likely" and 10% see it as unlikely. *Id.*

62 *Id.*

63 Deputy Treasury Secretary Wolin has emphasized the need to protect innovation in implementing the Dodd-Frank Act. Deputy Secretary Neil Wolin, Remarks at Georgetown University (Oct. 25), *available at* http://www.treas.gov/press/releases/tg923.htm ("We will protect the freedom for innovation that is absolutely necessary for growth. Our system allowed too much room for abuse and excessive risk. But as we put in place rules to correct for those mistakes, we have to achieve a careful balance and safeguard the freedom for competition and innovation that are essential for growth.")

ability of banking entities to transition in an orderly manner to the Volcker Rule and to engage in those investment activities expressly permitted by the Volcker Rule—precisely the results that Congress chose to avoid.

The Dodd-Frank Act clearly provides a delayed effective date for the Volcker Rule's restrictions and a further transition and conformance period to allow for an orderly transition to the Volcker Rule. Congress, in crafting these compliance time periods, clearly understood the need for long-term planning and wanted to allow banking entities ample time to adjust behavior to fit the new regulatory restrictions.[64]

This congressional mandate can only be achieved if the FRB issues clear guidance in its special rulemaking under Section 619(c). The FRB's special rules should give the maximum time to conform illiquid funds to the requirements of the Volcker Rule and should provide clear direction as to: (a) what constitutes an illiquid fund; (b) what funds will be eligible for conformance period extensions; and (c) what restrictions and limits will apply during the conformance period. We urge the Council to recommend the FRB to exercise its authority to address these issues clearly and promptly so as to avoid market disruptions and harm to financial stability.

A specific issue that must clarified is whether the extension for illiquid funds provided for in Section 619(c)(3) runs concurrently or consecutively with the ordinary two-year conformance period provided for in Section 619(c)(2). We believe that, as a matter of statutory interpretation, congressional intent, and public policy, the extension should be granted consecutively.

First, the statute clearly states that the FRB may "extend" the conformance period and that this "extension ... may not exceed 5 years."[65] The 5-year reference is not to the total conformance "period" but to the "extension."

Second, as mentioned in the preceding paragraphs with regard to the imposition of the Section 619(d) restrictions during the conformance period, the congressional intent was to provide for an orderly winding down and divestiture period that would minimize market disruptions.[66] As discussed in Section I.A.2 above, our fund investments have terms of ten or more years. A full extension period of seven years would allow the vast majority of the pre-existing funds to wind-down in accordance with their terms or divested in an orderly process. A shorter extension period may force banking entities to sell a higher number of illiquid fund interests on the secondary market, which could cause distressed prices resulting in investment losses for the banking industry.

---

64 *See* 156 Cong. Rec. S5899 (July 15, 2010) (statement of Sen. Merkley) ("The purpose of this extended wind-down period is to minimize market disruption while still steadily moving firms away from the risks of the restricted activities.").

65 Section 619(c)(3).

66 *See supra* note 64 and *infra* note 67 and the accompanying text.

Another matter the FRB should clarify in its special rulemaking is that the limits placed on investments in Section 619(d) of the Volcker Rule apply exclusively to investments made after the effective date of the rule and in reliance on the so-called "permitted funds" exception to the Volcker Rule's restrictions (Section 619(d)(1)(G)). Pre-existing investments, made prior to the effective date of the Volcker Rule, are governed by the separate and distinct conformance period requirements of Section 619(c). Put differently, the FRB should clarify that Section 619(d)'s Tier 1 cap and other restrictions apply only prospectively and, then, only to permitted funds. In no case should investments made by a banking entity prior to the effective date of the Volcker Rule count against its aggregate Tier 1 cap or be required to comply with the other requirements of Section 619(d) until the end of the conformance or wind-down period.[67]

It is important that the FRB confirm these readings of the Volcker Rule promptly. Absent clarity, banking entities with pre-existing investments that exceed the 3% Tier 1 cap will not know whether they may form new permitted funds and invest up to 3% in those funds or when they will be required to divest their pre-existing investments. This kind of near-term uncertainty is something Congress attempted to avoid, and we urge the Council to ask the FRB to address this issue in its special conformance period rulemaking.

To be clear, our reading of Section 619 and its legislative history would merely allow banking entities to wind down pre-existing investments during the conformance period (inclusive of all extensions), as Congress desired, and to structure new investments under the permitted funds exemption, subject to the restrictions that apply to this exemption. At the end of the conformance period (inclusive of all extensions), a banking entity would need to comply fully with the Volcker Rule, including Section 619's 3% Tier 1 cap.

III. THE REGULATORY AGENCIES SHOULD CLARIFY HOW THE VOLCKER RULE APPLIES TO FUNDS-OF-FUNDS (*QUESTIONS 3 AND 6*)

As described above, there are two types of funds: direct investment funds, which invest directly in companies, and funds-of-funds, which invest in other funds. Many investors use funds-of-funds to help them select and access the best direct investment fund managers.

While the Volcker Rule appears to contemplate both types of funds, it does not consistently and clearly specify how its requirements apply to funds-of-funds. The Council should direct the Regulatory Agencies to clarify that a permitted fund (properly structured under

67 We believe that the application of the Section 619(d) limits only to new investments is clear under the statutory construct. For example, there is no cross-reference in Section 619(c) to the limits of Section 619(d). We also believe that there is ample legislative history to support this reading. *See, e.g.*, 156 Cong. Rec. S5889 (July 15, 2010) (statement of Sen. Hagan) ("[S]ection 619(c)(2) ensures that the new investment restrictions under section 619(d)(1)(G)(iii) and section 619(d)(4)–including the numerical limitations under section 619(d)(4)(B)(ii)–will only apply to a banking entity at the end of the period that is 2 years after the section's effective date. This date for the regulators to begin applying the new rules can also be extended into the future for up to three 1-year periods under section 619(c)(2) and can also separately be extended for illiquid funds with contractual commitments as of May 1, 2010, under section 619(c)(3), on a one-time basis for up to 5 years. Only after all of these time periods and extensions have run will any of the limitations under section 619(d)(1)(G) and section 619(d)(4) be applied by regulators.").

Section 619(d)(1)(G)) may invest in other funds and that the requirements for sponsored funds set forth in Sections 619(d)(1)(G) and 619(d)(4) apply to a *sponsored* fund-of-funds, not to the underlying funds in which the fund-of-funds invests.

Congress intended this result. Senator Scott Brown, in his July 26, 2010 statement, provides:

> Another area of potential confusion is in the language governing "funds of funds." These are funds that invest in a wide range of other investment partnerships, hedge funds or private equity funds, so that investors can benefit from the good investment ideas of a variety of funds. Banks' investments in the fund of funds that they sponsor for clients are to be limited under this bill to 3 percent of the fund. But that fund, which will be comprised of, at a minimum, 97 percent client money, under Dodd-Frank, is not restricted as a percentage of any of those investment partnerships, hedge funds or private equity funds that it might be invested in, because the bank's exposure is still limited to 3 percent in the original fund, mitigating any chance of a concentration risk or bailout incentive.[68]

* * *

[68] 156 Cong. Rec. S6242 (July 26, 2010); *see also* Testimony of Paul A. Volcker Before the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate (Feb. 2, 2010) (noting a number of activities that would still be "within the province of commercial banks" under his proposed Volcker Rule, including "investment management and investment advisory services, including 'Fund of Funds' providing customers with access to independent hedge or equity funds").

We thank the Council for the opportunity to comment on the Study. If you have any questions, please do not hesitate to call Mary Dent at 650.321.1119.

Sincerely,

Mary Dent
General Counsel
SVB Financial Group

Sven Weber
President
SVB Capital

SVB›Financial Group

January 24, 2010

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

Re: Exemptions for Advisers to Venture Capital Funds

File No. S7-37-10
Release No. IA-3111 (the "*Release*")

Dear Ms. Murphy:

SVB Financial Group ("*SVB*") is pleased to submit these comments in response to the Securities and Exchange Commission (the "*Commission*") request for comment on proposed rule 275.203(l)-1 (the "*Proposed Rule*") under the Investment Advisers Act of 1940 (the "*Advisers Act*"). The proposed rule would define the term "venture capital fund" for purposes of Section 203(b)(l) of the Advisers Act, which was enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "*Dodd-Frank Act*").

It is critical that the Commission define venture capital funds accurately. If the definition is too broad, it may allow funds that pose systemic risk to our financial system to avoid registration. If too narrow, it would put an unnecessary financial burden on venture capital funds and the start-up companies they support, and encourage them to make business decisions that would stifle job creation, innovation and global competitiveness. Additionally, we believe that this definition may be used beyond investment adviser registration requirements. Any mistakes could have unintended consequences with broad-reaching effects.

We appreciate the Commission's thoughtfulness in creating the proposed rules; however there are several aspects that we believe need to be revised or clarified to avoid the unintended consequences mentioned above. All of these revisions will allow venture capital funds more flexibility to provide funding for small, growing business without contributing to any systemic risk. Specifically, we encourage the Commission to:

1. Revise the definition of qualifying portfolio companies to recognize that venture capital funds invest in other venture capital funds, and such investments are consistent with the policies underlying Section 203(b)(l). This can be accomplished by changing "any company" to "any entity" in section (c)(4), and adding the phrase "unless it is a venture capital fund under this section 275.203(l)-1" at the end of section (c)(4)(iv);

2. Revise the definition to recognize that venture capital funds buy shares from founders and other shareholders before or without buying shares directly from the issuing

portfolio company. This can be accomplished by revising section (a)(2)(i) to delete the phrase "of each qualifying portfolio company" prior to "owned by the fund";

3. Expand section (a)(2) to include funds that make loans to qualifying portfolio companies;

4. Revise section (a)(4) of the definition to allow venture capital funds to guaranty portfolio company debt without a 120 day time limit;

5. Clarify the term "in connection with..." in section (c)(4); and

6. Recognize that venture capital funds use capital call lines of credit and that an undrawn line of credit is not borrowing or debt.

BACKGROUND ON SVB FINANCIAL GROUP

SVB is a bank holding company and a financial holding company. Our principal subsidiary, Silicon Valley Bank, is a California-chartered bank and a member of the Federal Reserve System. As of December 31, 2010, SVB had total assets of $17.5 billion.

We are the premier provider of financial services for companies in the technology, life science, venture capital and premium wine industries. Since we began serving the technology and life science markets in 1983, we have become the most respected bank serving the technology industry and have developed a comprehensive array of banking products and services specifically tailored to meet our clients' needs at every stage of their growth.

Today, we serve more than 13,000 clients through 26 U.S. offices and through international offices located in China, India, Israel and the United Kingdom. We earn the vast majority of our income by providing banking and financial services to our clients. In addition to our core banking business, however, SVB (the holding company) also has sponsored venture capital funds, through our SVB Capital division, and made investments in certain third-party venture funds. Our regulators, the Federal Reserve Board and the California Department of Financial Institutions, regularly examine our funds business to ensure that it is being conducted in accordance with all applicable rules and regulations.

Our sponsored funds, managed by SVB Capital, are predominantly made up of third-party capital. We manage this capital for our fund investors, which include pension plans, charitable foundations and university endowments. We currently manage nine "funds-of-funds" that invest exclusively in venture capital funds managed by third-parties and five "direct investment funds" that invest directly into operating companies. Our direct investment funds, and the funds in which our funds of funds invest, make long-term investments in privately held companies in the information technology, life science and cleantech sectors.

Due to our multi-faceted role as banker, lender, investor and/or advisor to our nation's start-up companies, venture capital fund managers and their limited partner investors, SVB is uniquely positioned to see how changes in laws and regulations may affect this vibrant but increasingly challenged ecosystem, and we are deeply concerned about the potential for unintended consequences.

DISCUSSION

I. VENTURE CAPITAL FUNDS INVEST IN OTHER FUNDS

We believe that the definition of a venture capital fund should reflect Congress's perception of the purposes that venture capital funds serve in the overall economy. We agree with the Commission's characterization of this purpose:

> As a general matter, venture capital funds are long term investors in early-stage or small companies that are privately held, as distinguished from other types of private equity funds, which may invest in businesses at various stages of development including mature, publicly held companies. Testimony received by Congress characterized venture capital funds as typically contributing substantial capital to early-stage companies and generally not leveraged, and thus not contributing to systemic risk, a factor that appears significant to Congress' determination to exempt these advisers.

75 Fed. Reg. 77,190, 77,192 (Dec. 10, 2010) (footnotes omitted).

Congress' decision to exempt venture capital funds from the obligation to register with the Commission is part of a broader trend to differentiate venture capital from other types of private equity funds. There are two policy reasons driving this change. First, venture capital funds provide capital to early-stage companies that are creating jobs, curing diseases, and developing new technologies that improve the lives of millions of Americans. Second, venture capital funds do not pose any systemic risk to our financial system.[1]

---

[1] In light of this broader policy shift, it is possible that the Commission's definition of a venture capital fund will be used not only for determining which funds must register under the Investment Adviser's Act, but for other purposes as well. *See* Financial Stability Oversight Council, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds and Private Equity Funds, p. 62 (January 2011), which stated:

> "[A] number of commenters suggested that venture capital funds should be excluded from the Volcker Rule's definition of hedge funds and private equity funds because the nature of venture capital funds is fundamentally different from such other funds and because they promote innovation. The Council believes that the issue raised by commenters in this respect is significant.... The Council recommends that Agencies carefully evaluate the range of funds and other legal vehicles that rely on the exclusions contained in section 3(c)(1) or 3(c)(7) and consider whether it is appropriate to narrow the statutory definition by rule in some cases."

The Council specifically mentioned the Commission's current rulemaking as a potential approach for defining venture capital funds under the Volcker Rule. We believe the Commission should consider the broader range of potential uses in adopting a final definition of "venture capital fund" in this proceeding. At the same time, we believe the Commission should acknowledge in its final Order that the definition adopted in this proceeding is intended to be used for investment adviser registration

Venture capital funds provide capital to early-stage companies through one of two equally important paths: one, by investing directly into companies, and two, by investing through other venture capital funds. Funds use the second approach for a variety of reasons. For example, many venture capital funds invest a portion of their assets in "seed" or "angel" funds to help them identify new technologies, companies and entrepreneurs. Others invest through intermediate partnerships or other entities to comply with international regulations or to benefit specific tax-exempt investors such as charitable foundations. And still others invest primarily or exclusively via other venture capital funds because they believe it is the most effective way to deploy their clients' funds. In all of these cases, the funds provide capital to the same early-stage companies; they simply do so through a different path.[2]

All of these investment strategies are consistent with the objectives cited in the Release. They all provide capital to early-stage or small companies that are privately held, without creating any systemic risk. There is no reason to exclude venture capital funds that make their investments indirectly through other venture funds from the proposed definition.

In the Release, the Commission states that there is no indication that Congress intended the venture capital exemption to apply to funds of funds. *See* 75 Fed. Reg. at 77,199. However, there is no indication that Congress intended to exclude such funds from the definition, and at least one other federal regulatory agency – the Federal Reserve Board – has indicated that a fund of funds should be included in definitions that apply to the underlying funds in which it invests.[3]

If a fund of funds invests only in funds that separately qualify as venture capital funds – and not in any other type of fund – it *is* a venture capital fund, and there is no policy reason to exclude it from the Commission's definition. Like other venture capital funds, venture capital funds of funds contribute substantial capital to early-stage companies; generally not leveraged; and do not contribute to systemic risk. (And if a venture capital fund of funds chose to use debt,

---

purposes, and may not be suitable for all purposes. This would be consistent with the approach used by the Commission and other regulatory bodies in other cases. For example, the Commission and other agencies have adopted different definitions for terms such as "affiliate" and "control" under different regulations, in light of the different purposes of those regulations.

2 SVB, through its SVB Capital managed funds of funds, has invested in dozens of top-tier venture capital firms since 2000. Approximately 40% of those firms have venture capital funds that have invested in other venture capital funds, managed by separate venture capital firms, and the trend appears to be increasing.

3 *See* Federal Reserve, Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 75 Fed. Reg. 72,741, 72,744 (Nov. 26, 2010) (proposing to define an illiquid fund as a fund that invests not only directly in illiquid assets but also "in other hedge funds or private equity funds" that also invest in illiquid assets); *see also* Financial Stability Oversight Council, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds and Private Equity Funds, pp. 57-58 (January 2011) (citing testimony of Paul Volcker before the Senate Banking Committee that "funds of funds" should remain permissible under the Volcker Rule because they are a means of efficiently providing customers with access to independent hedge funds or private equity funds).

it would be bound by the same rules that restrict the amount and type of debt a venture fund may use without forfeiting its exemption under the registration rules.)

In fact, there are strong policy reasons *for* including venture capital funds of funds in the definition. Venture capital funds of funds are a critical, stable source of funding for the venture capital funds and the portfolio companies in which they invest. They are part of the same venture capital/emerging company/innovation/job creation ecosystem and should not be treated differently from other venture capital funds.

To accomplish the change that we propose, the Commission should revise section (c)(4)(iv) to include investments in other venture capital funds as "qualifying portfolio companies." Otherwise the rule will unnecessarily discriminate between different types of venture capital investment strategies and discourage investments that create jobs, foster innovation and enhance our county's global competitiveness. Other sections of the definition properly define venture capital funds and protect against advisers to other funds from trying to improperly avail themselves of the venture capital exemption.

II. THE DEFINITION SHOULD NOT PROHIBIT STAND-ALONE SECONDARY PURCHASES

The Commission correctly recognized that most venture capital funds acquire most of their portfolio company securities directly from the company, rather than from existing shareholders in so-called "secondary" transactions. However, there are some very important exceptions to this generalization. As a result, the proposed rule, as drafted, will have an unintended and adverse outcome.

Many venture capital funds make secondary investments as an entry into a company, as part of a strategy to boost returns for their investors (because such shares can often be purchased at a discount), as a way to provide liquidity to members of the management team, or as a way to increase their ownership without increasing overall dilution, typically when another investor is unwilling or unable to maintain their investment. A secondary purchase in a privately held, emerging company is just as much a venture capital investment as a primary purchase.

Secondary purchases by venture funds, however, are fundamentally different from "buyout" transactions. The industry meaning of a buyout is buying all or effectively all of a company's shares and taking control of all management decisions, not purchasing a minority interest in a private company from an existing shareholder and engaging in the other types of long term, growth-enhancing engagement that typifies venture capital investors.

Allowing venture capital funds to make secondary purchases is also important in preserving capital flows to startups and other high growth companies. As noted above, there may be times in a company's evolution when an existing investor wants to reduce or eliminate their holding, or a member of the management team wants to gain liquidity before the company goes public or is acquired. This is particularly true as the time it takes to nurture a startup to an "exit" has lengthened over the past decade. If venture firms cannot purchase these secondary investments without forfeiting their status under the registration rules, companies will find it more difficult to manage through these situations.

For these reasons, the Commission should modify its approach in Section (a)(2)(i). The Commission should retain the concept that, across a portfolio, a venture fund will be predominately made up of primary investments (i.e., of shares acquired directly from the issuing company). The Commission, however, should eliminate the requirement that at least 80 percent[4] of the shares of *each* portfolio company must be primary investments and the concept that secondary investments, to be permitted, must be tied to primary investments in the same company. Specifically, the Commission should delete the phrase "of each qualifying portfolio company" in section (a)(2)(i), so that the percentage limit applies to the overall fund and all of its investments, not on a company-by-company basis.

III. FUNDS THAT MAKE LOANS TO QUALIFYING PORTFOLIO COMPANIES SHOULD BE INCLUDED IN THE DEFINITION OF A VENTURE CAPITAL FUND

One of the main purposes of the venture capital exemption is to avoid restricting the flow capital to technology start-up companies, which create jobs and foster innovation. Whether a fund provides this capital by making a loan or an equity investment is irrelevant. Both provide capital to technology start-up companies, and loans do not create any more systemic risk than equity investments. As long as the venture capital fund provides capital to qualifying portfolio companies, does not use significant leverage, does not make significant investments in public markets and does not allow its investors to redeem their interests in the ordinary course, it should be governed by the same policy. The fact that a fund provides capital in the form of debt (making loans) rather than equity (buying stock) does not make it any less critical to job creation, innovation and global competitiveness or any more likely to create systemic risk.

In the Release, the Commission asks whether the definition of a venture capital fund should "include funds that invest in debt, or certain types of debt, issued by qualifying portfolio companies, or make certain types of loans to qualifying portfolio companies." See 75 Fed. Reg. at 77,196. The answer is yes. So long as the loans are made to qualifying portfolio companies and the fund itself otherwise qualifies as a venture capital fund, this would not allow other types of fund advisers to avail themselves of the venture capital exemption from registration.

This can be accomplished by changing "equity securities" to "securities" in section (a)(2), replacing the equity securities definition in section (c)(2) with a customary definition of "securities" and clarifying the term "in connection with" as discussed in Section V, below.

---

4 Many venture capital funds invest more than 20% of their capital via secondary investments. Some invest in technology startups primarily or exclusively through secondary purchases. We believe the definition should focus on other factors that more effectively differentiate a venture capital fund from other funds, such as the lack of leverage and focus on investments in technology start-up companies. *See* SVB Financial Group Comments to Financial Stability Oversight Council, dated November 5, 2010, File No.2010-25320, pp. 7-8. To the extent the Commission believes a threshold on primary or secondary investments is needed, we encourage the Commission to make it as flexible as possible.

IV. VENTURE CAPITAL FUNDS SHOULD BE ALLOWED TO GUARANTY PORTFOLIO COMPANY DEBT FOR LONGER THAN 120 DAYS

The proposed rule would prohibit a venture capital fund from guaranteeing the debt of its portfolio companies for longer than 120 days. (*See* Section (a)(4)). This restriction is unnecessary and would make it more difficult, if not impossible, for some start-up companies to obtain credit for working capital.

A bank will often require a guaranty for new loans or to extend existing loans to start-up companies that are not performing to plan. A venture capital fund may provide such a guaranty to allow its portfolio company to continue operations while it attempts to find a buyer (a "bridge-to-sale" loan) or conduct an orderly wind-down that protects the company's intellectual property assets. This often takes longer than 120 days.[5] Limiting such guarantees would only make it more difficult for such companies to obtain credit, and in some cases force the closure of portfolio companies with a resulting loss of jobs.

Extending or removing the time limitation for guarantees would not allow venture capital funds to use extensive leverage. Qualified portfolio companies would still be prohibited from borrowing to fund or finance the venture capital fund's investment in the company.

V. THE COMMISSION SHOULD CLARIFY THE MEANING OF "IN CONNECTION WITH"

The proposed rule prohibits qualifying portfolio companies from borrowing "in connection with" the fund's investment in the company. The term "in connection with" is vague. According to the Release, this provision is meant to prevent a typical leveraged buyout transaction where the portfolio company incurs debt to finance a private equity fund's acquisition of the company. *See* 75 Fed. Reg. at 77,197-98. We agree this is an important consideration, but alternative language would accomplish this objective more effectively, and provide certainty to venture-backed companies looking to borrow for working capital or other needs that do not involve financing a fund's investment in the company.

Banks commonly consider the equity investments made (or expected to be made) by a venture backed company's investors in evaluating the company's creditworthiness. This is because most of these companies are not yet profitable – some do not even have revenues or a fully-developed product. Therefore, one could infer that many loans to venture-backed start-up companies are in some way "in connection with" the fund's equity investment.

Although we do not think this is the Commission's intended meaning of "in connection with the private fund's investment," using more specific language would provide greater certainty for early-stage venture-backed companies seeking to borrow for working capital purposes. Using the terms "to finance," "to fund," or "to leverage" the private fund's

---

5 SVB has received guarantees from venture capital investors that have been in effect for as long as 3 years, which allowed those companies to stay in existence, preserve valuable intellectual property and delay job losses.

investment would help ensure that venture backed start-ups do not lose access to credit and avoid other unintended consequences.

In the Release, the Commission asks whether the test for a qualifying portfolio company should be whether the company currently intends to borrow at the time of the fund's investment. *See* 75 Fed. Reg. at 77,198. It should not. Such a definition would be extremely difficult to interpret in practice, and would fail to recognize that the purpose of the test is to exclude companies that are incurring debt to finance the fund's equity investment, not to exclude companies that borrow in the ordinary course of their business and to balance in an appropriate way the mix of debt and equity in their overall capital structure. *See* 75 Fed. Reg. at 77,198-99.

A test that depends on how the portfolio company uses the proceeds of borrowing would be more appropriate. For example, the test could exclude borrowings the proceeds of which will be distributed to the venture capital fund or to any selling shareholder. Excluding only companies that use such proceeds to return capital to the fund or to allow the fund to acquire a controlling majority stake in the company using debt at the company level to fund its purchase would be a more effective approach. *See* 75 Fed. Reg. at 77,199.

VI. VENTURE CAPITAL FUNDS USE CAPITAL CALL LINES OF CREDIT

In the Release, the Commission asks whether venture capital funds use lines of credit repeatedly but pay the outstanding balance amounts in full before drawing down additional credit. They do. *See* 75 Fed. Reg. at 77,201.

Venture capital funds use a capital call line of credit to address the issues of certainty and expediency. Too often, investments do not close as timely as expected or the exact amount of cash needed changes on short notice. There are two solutions to the inherent uncertainty of when and how the "closing" of a venture capital financing will occur.

One is that a fund can call capital from its limited partners sooner, and in a greater amount, than it expects to need. The problem with this approach is that it forces the venture capital fund to hold excess cash, which sits unused and lowers the returns a fund can provide to its investors.

The second solution is a capital call line of credit. Using the line of credit, the fund can always draw exactly what is required and exactly when it is required. The capital call line can be quickly repaid by calling capital from limited partners immediately after the closing of the investment. Additionally, for small investments and for the collection of management fees, a fund may want to delay capital calls to lessen the administrative burden that frequent calls place on a pension fund, foundation or endowment. Therefore, many funds prefer to use a capital call line to aggregate their needs into one quarterly or in some cases bi-annual capital call.

It appears that the Commission's proposed 120 day debt limit would cover any amounts under a line that remain outstanding for more than 120 days. We encourage the Commission to increase this time limit to 180 days, to allow venture capital funds that prefer to make bi-annual capital calls to continue to do so. We also believe the 15 percent limitation should not apply to capital call lines or the limit should be increased to allow venture capital more flexibility in managing their cash flows and maximizing returns for investors. So long as only capital call lines of credit were exempt from the limitation, this would not pose any added systemic risk to our financial system. A 180-day limit alone would sufficiently prevent such risk. *See* 75 Fed. Reg. at 77,202.[6]

Finally, we urge the Commission to refrain from anything that would restrict a venture capital fund's ability to have an open *undrawn* line of credit for as long as needed by the fund. An undrawn line of credit is not leverage, it is simply access to credit, and poses no systemic risk whatsoever.

VII. ADDITIONAL COMMENTS

The Commission asks additional questions in the Release that we address here.

A. *Public Companies*

The Commission asks whether the definition should exclude a venture capital fund that holds shares in their portfolio companies after those companies have gone public – or impose a time limit on how long a fund can hold such securities. *See* 75 Fed. Reg. at 77,195. It should not. Creating such a restriction would force funds to sell shares prematurely, potentially flooding the market and depressing the share price of newly public companies. This could make it more difficult for newly public companies to raise follow-on rounds of capital in the public markets, and could create a transfer of wealth from the pension funds, charitable foundations, university endowments and other venture capital investors to hedge funds, private equity funds or other public-market traders. Conversely, it could harm public shareholders by making it difficult or impossible to obtain a lock-up agreement with pre-existing private investors.

Additionally, such a restriction could require venture capital fund managers to prematurely resign from the boards of their newly public portfolio companies, depriving those companies of valuable management advice. This is in the interest of neither the company nor its new investors, and could have the perverse effect of making it even more difficult for companies to go public in the United States and to perform strongly as newly public companies.

If any modifications are appropriate in this area, it would be to allow venture capital funds to invest a percentage of their capital in public companies, perhaps limited to companies in which the fund has an existing investment. This would allow the fund to continue to support its portfolio company after an IPO, which is common for venture capital funds that invest in more capital-intensive industries such as biotechnology and clean energy technology.

---

6 Capital call lines do not present excessive risk to the funds or lenders, and in no way create any systemic risk. They are backed by the fund's legal right to call capital from limited partners, who face serious financial and reputational consequences if they fail to meet the call. Silicon Valley Bank has a large portfolio of capital call lines to venture capital and private equity funds, and has engaged in this type of lending for an extended period. Our loss experience with these loans is close to zero – even during the recent financial crisis.

B. ***Equity Securities***

In the Release, the Commission asks whether it should consider a more limited definition of equity security. *See* 75 Fed. Reg. at 77,196. It should not. As discussed above, the definition should be expanded to include funds that hold debt securities (i.e., loan money) to qualifying portfolio companies. In addition, venture capital funds often invest in partnerships, limited liability companies and other forms of entities, so it would not be appropriate to restrict the form of entity in which a fund invests.

C. ***U.S. Treasuries and Cash Holdings***

The Commission asks whether the proposed rule's provisions related to investments in U.S. Treasuries should specify a shorter or longer maturity period and whether the provision for cash holdings is too broad or too narrow. *See* 75 Fed. Reg. at 77,197. Investments in U.S. Treasuries and cash holdings pose no systemic risk whatsoever. There is absolutely no reason to make these provisions more restrictive and every reason to make them as flexible as possible to avoid any unintended consequences.

D. ***Funds Subject to Non-U.S. laws and Investments in Non-U.S. Companies***

In the Release, the Commission asks whether the definition of a venture capital fund should be limited to funds formed under U.S. law, funds that invest exclusively or primarily in the U.S. or funds that invest only companies operating in non-financial sectors. *See* 75 Fed. Reg. at 77,197. The answer is no. None of these activities pose systemic risk issues and, as recognized by the Commission, there is no indication that Congress intended such restrictions or would support them.

E. ***Portfolio Company Use of Capital***

In the Release, the Commission asks whether focusing on a portfolio company's use of capital received from a venture capital fund imposes any unnecessary burdens on a company's operations or business. *See* 75 Fed. Reg. at 77,199. It most certainly could. Companies need to be able to repurchase shares from departing employees and to exercise rights of first refusal to prevent shareholders from selling to competitors or expanding the Company's shareholder base to the point of becoming a de-facto public company.

F. ***Managerial Assistance***

The Commission asks whether the rule should specify that a fund or its adviser actually provide managerial assistance, rather than only offer assistance. *See* 75 Fed. Reg. at 77,201. It should not. In some instances, a technology start-up company may need only funding and not want managerial assistance. Effectively prohibiting this type of investment would not further the policy of reducing financial and administrative burdens on advisers who provide capital exclusively to technology start-up companies in a manner that poses no systemic risk. In fact, any requirement related to managerial assistance is unnecessary and fails to differentiate venture capital funds from many other types of investment funds, which also provide managerial assistance to the companies in which they invest.

G. ***"Retail" Investors***

The rule should not specify that venture capital funds do not have "retail" investors. *See* 75 Fed. Reg. at 77,205. While true – if "retail" investor means non-accredited investors or investors from the general public – it would not differentiate venture capital funds from many other types of funds and would create a confusing and unnecessary additional rule. Effective limitations related to accredited investor requirements are already contained in existing securities laws.

H. ***Redemption***

We agree with the way the Commission has addressed redemption rights. In the Release, the Commission asks whether the phrase "extraordinary circumstances" is sufficiently clear to distinguish the way redemptions work in a venture capital fund from a hedge fund. *See* 75 Fed. Reg. at 77,203-04. It is. Redemptions from venture capital funds are usually limited to legal or regulatory restrictions that are specific to certain types of investors, such as those that are subject to ERISA or bank holding company regulations. The rule should not define a minimum investment period, because these regulatory issues – either due to changes in the law or changes specific to the investor – can happen at any time.

Additionally, the Commission should not impose a limitation on the amount of capital that can be redeemed, because it may prevent investors from complying with regulatory requirements or limit venture capital funds ability to accept investments from pension funds and other investors subject to ERISA or other regulations.

* * *

We thank the Commission for the opportunity to comment on the Proposed Rule. If you have any questions, please do not hesitate to call Mary Dent at 650.320.1119.

Sincerely,

Mary Dent
General Counsel
SVB Financial Group

Jason Doren
General Counsel
SVB Capital

Sven Weber
President
SVB Capital