



February 16, 2005

**VIA Email**

Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, D.C. 20549-0609  
*rule-comments@sec.gov*

Re: Comment of the National Venture Capital Association on Release No. 33-8511; 34-50831; IC-26691; File No. S7-41-04.

Dear Mr. Katz:

The National Venture Capital Association (NVCA)<sup>1</sup> is pleased to comment on these proposed revisions to Regulation M. We are most interested in the changes as they apply to aftermarket trading of initial public offerings. NVCA represents the vast majority of venture capital under management. Venture capital funds are large shareholders of many pre-IPO companies. NVCA encourages all efforts to improve the fairness and efficiency of the IPO process and the IPO market. Over the past several years, nearly one-half of all IPO issuers were venture-backed companies. The IPO market and the going-public process are central to the success of venture investing and the virtuous economic cycle of liquidity and re-investment into new ventures.

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<sup>1</sup> The National Venture Capital Association (NVCA) represents approximately 450 venture capital and private equity firms. NVCA's mission is to foster greater understanding of the importance of venture capital to the U.S. economy, and support entrepreneurial activity and innovation. The NVCA represents the public policy interests of the venture capital community, strives to maintain high professional standards, provide reliable industry data, sponsor professional development, and facilitate interaction among its members. For more information about the NVCA, please visit [www.nvca.org](http://www.nvca.org).

Venture funding is a major factor promoting innovation and entrepreneurial businesses. In 2004, venture capital (VC) funds invested \$20.8 billion in more than 2800 companies, the fifth largest amount ever in the history of venture capital. Eighty-five percent of these companies were in information technology, medical/health or life sciences. The success of venture investing is encouraging greater capital flow to these types of companies. At the end of 2003, VC firms had an estimated \$258 billion under management, up from \$32 billion in 1990.

Consequently, in recent years the NVCA has encouraged numerous efforts by the SEC, the NASD and the New York Stock Exchange to enhance the fairness of the IPO market and the underwriting process. Our recent comment letter on SRO allocation and distribution rules encouraged continuous review of the fairness of these rules. Equally important to venture investing -- and the benefits it brings to the economy<sup>2</sup> -- is the efficiency of the IPO process.

NVCA views the IPO market as a capital raising event for issuers and an opportunity for venture capital investors to eventually gain liquidity. Our views reflect this perspective rather than that of a buyer or seller in an IPO. Genuine improvements to the efficiency of the offering process will help lower the cost of venture capital and will redound to the benefit of the overall economy.

Shares of IPO companies owned by venture capital funds are generally not sold in the initial offering. VC funds shares are usually “locked up” for 180 days after the initial offering. Consequently, venture capital funds view IPOs as successful when they produce cash proceeds for the issuing company and result in a deep, liquid secondary market for the company’s stock into which venture funds will eventually sell shares. Therefore, NVCA fully supports the anti-manipulative purpose of Regulation M as well as efforts of the underwriting industry to assure smooth initial offerings.

## **NVCA’s Specific Comments**

### **1. Amendment to Rule 101: expansion of the restricted period for IPO**

As we understand the propose change, it would, in most cases, expand the restricted period significantly into the period prior to the filing of the registration statement. The proposal to apply the full restrictions of Regulation M at the point when an IPO issuer reaches an understanding with its underwriter is a significant change. These restrictions could limit legitimate activities and do not seem to be justified by the examples offered in the Proposing Release. Therefore, if the Commission believes there is a need to expand the restricted period further into the pre-IPO period in order to deal with certain manipulative practices, it should

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<sup>2</sup> Venture capital occupies a unique and valuable role in the U.S. economy. From 1970 – 2003 venture capital funds invested \$338.5 billion dollars into more than 21,600 U.S. companies. Companies that received venture financing between 1970 and 2003 accounted for 10.1 million jobs and \$1.8 trillion in revenue in 2003, representing approximately 9.4% of total U.S. jobs and revenues. These companies registered 6.5% and 11.6% gains in jobs and revenues respectively between 2000 and 2003 while national employment fell 2.3% and U.S. company revenues rose 6.5%. Prominent U.S. companies that received venture financing during their growth phases include: Microsoft, Federal Express, AOL, Apple, Office Depot, Intel, Home Depot, Cisco, Compaq, Genentech, Amgen, and Starbucks. More recent beneficiaries of venture funding include: e-Bay, JetBlue, Seagate, and Google. Sources: Press Release, National Venture Capital Association, “Venture backed companies outperform peers in 10 industries during U.S. economic downturn, new study shows,” July 20, 2004; “*Venture Impact 2004: Venture Capital Benefits to the U.S. Economy*,” commissioned by the NVCA and conducted by leading economic analysis and forecasting firm Global Insight (formerly known as DRI-WEFA), p. 2. Global Insight constructed a database of more than 20,000 U.S. companies that received venture capital investment at some point between 1970 and 2003. From this database, Global Insight was able to measure the number of jobs and revenues these companies contributed to the U.S. economy in the years 2000 and 2003. A copy of the study is available at [www.nvca.org](http://www.nvca.org). Information on the study can also be found at [www.globalinsight.com/nvca](http://www.globalinsight.com/nvca).

more narrowly target those practices and continue to allow legitimate transaction which might otherwise be impaired.

**Amendments to Rule 104: regulating activities in connection with an offering**

- A. The addition of “any referenced securities” to the exemption is an appropriate clarification.

NVCA supports the proposed amendment to Rule 104(j)(2) which explicitly adds an exemption for “any reference securities” in conformity with the exempting language in Rules 101 and 102.

- B. The elimination of penalty bids diminishes the likelihood that IPO shares will be allocated to long-term investors as opposed to flippers.

NVCA appreciates the Commission’s intent to eliminate practices that interfere with the normal workings of supply and demand in the IPO market. Artificial restraints on the ability of holder to sell their securities can affect supply and demand for the stock. However, we believe that penalty bids do not restrict buyers or sellers in the IPO market. Nor should they influence the supply or demand for a new issue.

We view penalty bids as supporting a sound policy in favor of allocating newly issued shares to investors who want to hold the stock for long-term appreciation rather than short-term trading profits. We see penalty bids as supporting this policy insofar as they are a disincentive for brokers to allocate IPO shares to “flippers.”<sup>3</sup>

We have written in support of the proposed changes to NASD and NYSE rules that would prohibit discriminatory restrictions on flipping, especially since these rule changes are intended to avoid discrimination against individual investors. Furthermore, we understand that penalty bids are not widely used for operating company IPOs and that the prohibition on selective penalty bids may make their use less likely still. Nonetheless, we opposed the proposal to prohibit penalty bids for three reasons.

First, penalty bids promote an orderly market for newly offered shares by providing an incentive for selling brokers to favor purchasers who will hold the shares for a minimum period of days, usually thirty, rather than flipping for a trading profit.

Second, penalty bids promote the interests of issuers and the goals of capital formation by matching more patient capital with companies that generally need it. While penalty bids may not work for every offering, this mechanism has been developed by market intermediaries to meet the desire of their issuer-clients to place shares in the hand of investors, rather than flippers.

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<sup>3</sup> We use the term “flipper” in the sense that “flipping” is defined in proposed NASD Rule 2712 on IPO Pricing and Trading Practices (SR-NASD-2003-140) – one who sells of stock within 30 days of the initial offering in which it is acquired.

Potential flippers, including professional traders, who seek quick profits in an IPO, may be willing to pay more for IPO shares, but they are indifferent to the long-term health of the new company. A much different kind of purchaser, the long-term investor, promotes an orderly and efficient IPO as a capital raising event.

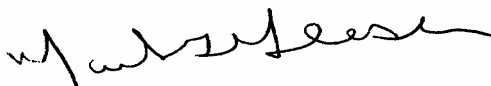
Third, and equally important, we do not see how penalty bids interfere with market forces. Indeed, penalty bids are a response to market forces. Issuers seek a smooth offering that result in shareholders with relatively patient capital. Penalty bids are a means for underwriters to satisfy this reasonable demand of issuers -- clients for whom they compete in an open market. Therefore, elimination of penalty bids is in fact an intrusion into market forces. The proposal would eliminate a legal mechanism for satisfying a seller of securities that is interested in a long-term relationship with investors more than in merely selling shares randomly to any buyer.

Furthermore, there is no basis for assuming that penalty bids must make an investor less likely to sell his or her shares.<sup>4</sup> Investor-purchasers hold the shares of new public companies for their own reasons. Shares sold subject to a penalty bid are as liquid as any others. However, the existence of the penalty bid encourages the broker to place IPO shares in the hands of investors rather than flippers or traders. This is a policy goal worth pursuing. Whether penalty bids are a useful tool for promoting this policy or meeting this need should be determined by the market, not by the Commission. Therefore, we recommend that the proposed amendment to eliminate penalty bids be withdrawn.

## Conclusion

For the reason stated in this letter, NVCA supports certain proposed amendments to Regulation M. We oppose the broad extension of the restricted period into the pre-IPO timeframe and elimination of penalty bids, which serve issuers' interests and orderly IPO markets. I would be pleased to discuss these comments with the Commission or the staff.

Sincerely yours,



Mark G. Heesen  
President

cc  
All Commissioners

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<sup>4</sup> Any coercive effect on a holder from a penalty bid could be avoided by prohibiting the disclosure of the existence of a penalty bid thus ensuring that the purchaser will interact freely with other holders, buyers and sellers in the marketplace.