U.S. Securities and Exchange Commission

SMALL BUSINESS CAPITAL FORMATION ADVISORY COMMITTEE

May 21, 2021

The Honorable Gary Gensler
Chair
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1070

Dear Chair Gensler:

On behalf of the SEC Small Business Capital Formation Advisory Committee, we are pleased to submit the below findings and recommendations approved at the Committee's April 30, 2021 virtual meeting. During that meeting, we explored ways to build upon our August 2020 findings by encouraging the Commission to improve access to capital for underrepresented founders and investors, including women, minorities, and founders outside of prominent tech hubs. In homing in on solutions, the Committee noted the following:

1. Recent trends show that many companies in established technology ecosystems are successful in raising capital. However, those figures leave out many entrepreneurs in other areas of the country and industries who struggle to raise the capital needed to grow and scale. The challenges are particularly acute for companies who are pre-revenue, making bank capital largely inaccessible. In particular, founding teams outside of tech hubs struggle to raise Series A capital, typically in the $3 million to $10 million range, after which point companies can more readily attract Series B capital from growth-oriented investors.

2. Pattern matching—or the process of making investment decisions that replicate patterns of who a successful entrepreneur has looked like in the past—perpetuates a cycle that has concentrated capital in limited geographies, ethnicities, genders, and educational backgrounds. Women and minority founders continue to struggle to raise capital and spend more time raising rounds of funding, relative to their White, male counterparts.

3. Many larger institutional investors express interest in supporting diversity, equity, and inclusion through investments in emerging fund managers and underrepresented founders. However, the combination of their minimum investment requirements (e.g., $15 million to $20 million) coupled with their maximum exposure within a single fund (e.g., 10% of the fund's AUM) functionally rules out direct investments by institutional investors in smaller, emerging funds, including regional Seed and Series A funds, which have the potential to meaningfully impact diversity of entrepreneurs raising capital.

4. Early-stage investors play an active role with their portfolio companies by providing hands-on support to founders, participating in board meetings, and supporting customer attraction strategies. Proximity to portfolio companies changes how early-stage investors evaluate investment opportunities.

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Additionally, the number of companies that the investor can actively mentor limits the number of investments that they can make. As a result, larger venture funds tend to invest larger amounts in a handful of later-stage companies, while smaller funds tend to invest smaller amounts in a proportionate handful of earlier-stage companies. A fund of funds model—where a larger fund invests in smaller, regional funds—could unlock capital otherwise competing for late-stage allocations and benefit smaller companies in emerging entrepreneurial ecosystems. However, the limitations on exempt reporting advisers' qualifying investments currently make this structure impracticable given the other competing demands on the 20% non-qualifying basket, including public offering commitments and secondary liquidity for founding teams.

5. First-time fund managers and smaller funds are declining in number and size, threatening access to the earliest stage capital that is catalytic to new companies' success. For emerging fund managers, the ability to pool more investors in a fund presents a promising pathway to raise a more impactful fund, while also offering diversification that decreases portfolio risk for angel investors who would otherwise be investing independently. However, the current qualified venture capital fund size limit of $10 million under Section 3(c)(1) of the Investment Company Act of 1940 is too low for a viable fund to cover its operational costs without charging an outsized fee to its investors.

In light of the foregoing observations, the Committee recommends the following changes:

1) With respect to the "qualifying venture capital fund" exemption in Section 3(c)(1) of the Investment Company Act of 1940:
    a. increase the current $10 million limit on the aggregate amount of capital contributions and uncalled committed capital to $150 million; and
    b. increase the number of permitted beneficial owners from 250 to 600.

2) Amend the "venture capital fund" definition under Rule 203(l)-1 of the Investment Advisers Act of 1940 to permit venture capital "fund of funds" investments by treating an investment in another venture capital fund, which itself meets the requirements of Rule 203(l)-1, as a "qualifying investment."

Respectfully submitted on behalf of the Advisory Committee,

Carla Garrett
Committee Chair

Jeffrey Solomon
Committee Vice Chair