Ladies and Gentlemen:

I appreciate the opportunity to submit comments in response to your Agencies’ joint notice of proposed rulemaking on implementing the “Volcker Rule,” part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”).

I am the Executive Director of the Berkeley Center for Law, Business and the Economy (BCLBE) which is the University of California at Berkeley, School of Law's hub for rigorous, relevant, empirically based research and education on the interrelationships of law, business, and the economy. We endeavor to inform students, policymakers and the public of the implications of this innovative work to promote positive outcomes on business operations, economic growth, and market efficiency. Our interdisciplinary approach to basic research, timely policy research, curriculum innovation, and public education empowers current and future leaders in business, law and policy to tackle the most pressing problems of today and tomorrow.¹

¹ For more information about the Berkeley Center for Law, Business and the Economy, visit our webpage: http://www.law.berkeley.edu/bclbe.htm
Your work to implement the Volcker Rule has important implications for the health of the U.S. economy. Properly implemented, the Volcker Rule will help to curb risky activity within banks and promote the integrity of the U.S. financial sector. At the same time, it is very important that you do not adopt regulations that expand the rule’s scope beyond its intended purpose. My comments here address one area of particular concern where the proposed rule potentially expands beyond Congress’ intended purpose, posing potentially adverse consequences for U.S. economic development in general, and California’s economic development in particular. Specifically, my comments focus on Question 310, which concerns the appropriate treatment of venture capital funds under the rule.

In Title IV of the Act (which requires registration of certain private investment funds under the Investment Advisors Act of 1940), Congress made clear that private equity funds and venture capital funds merit separate regulatory considerations when it comes to the risks they pose for financial stability. The reasons for this differentiated regulatory treatment were discussed at length in the legislative history of the Act as well as in the notice-and-comment proceedings pertaining to the implementation of Section 407 of Title IV. Simply stated, Congress was well aware of the importance in this country of venture capital finance to the formation and development of technological innovation, the creation of new enterprise, and the positive effects of new business formation on job creation and the economy in general. Congress was also sensitive to disturbing our unique venture capital ecosystem by imposing the burden of a registration requirement under the Advisors Act when there was so little evidence that venture capital funds contributed to the Financial Crisis. This is in contrast to traditional private equity funds and hedge funds, which while not necessarily at the epicenter of the Crisis, generally seek to produce investment returns through leveraged capital structures.2 And if there was one common characteristic of the firms that set off the Financial Crisis, it was their reliance on leveraged capital structures.

Consistent with this distinction between the risks posed by private equity and hedge funds and the risks posed by traditional venture capital funds it is notable that Congress chose to use the terms “private equity fund” and “hedge fund” in implementing the investment restrictions in Section 619 of the Act rather than the more general term “private fund” that it used in implementing the Advisor Act registration requirement in Title IV. While “private fund” was defined broadly to capture both private equity and venture capital funds, Congress took care to distinguish between “private equity fund advisors” (see, e.g., Section 408) and “venture capital fund advisors” (see, e.g., Section 407). The more specific prohibition in Section 619 of investments by banks into “hedge funds and private equity funds” would thus appear to reflect Congress’ concern with only these two types of private funds and not venture capital funds.

This perspective is further confirmed by examination of the legislative history of Section 619 of the Act. As the Act’s co-author, Senator Dodd stated in colloquy with Senator Boxer,

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2 Typically, leveraged returns to private equity funds and hedge funds are obtained either at the level of the business in which a fund invests (as in the case of a classic leveraged buyout fund) or at the level of the securities held by the fund (as in the case of a hedge fund with exposure to certain derivatives).
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.\(^3\)

He further added that “[i]n 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(J).”\(^4\) Similar sentiments were expressed by other members of Congress.\(^5\)

Of course, to say that Congress did not intend for the Volcker Rule to apply to venture capital investments does not necessarily satisfy the mandate in Section 619(d)(1)(J) to determine why such investments “promote and protect the safety and soundness of the banking entity and the financial stability of the United States.” On what basis could it be found that venture capital investments meet this standard—a conclusion undoubtedly reflected in sentiments such as those expressed by Senator Dodd above?

First, the structure of most venture capital investments pose few of the financial stability risks generally associated with private equity and hedge funds. While the literature on “financial stability” is diverse with no single definition of the term having emerged, a number of commonly cited attributes of financial instruments are often associated with financial instability. These include, for instance, size, interconnectedness, lack of regulatory scrutiny, and the use of leverage.\(^6\) Leverage, for instance, accentuates returns, thus amplifying not only the possibility of significant, non-linear growth of returns but also non-linear growth of losses. Similarly, investments (such as those associated with certain derivative transactions) that rely on balancing an array of different contractual obligations come with significant basis risk that is difficult to manage while potentially transmitting financial losses across multiple counter-parties. Stated in terms of basic corporate finance theory, financial instability tends to result from poorly managed financial risk (such as that created by leverage) as opposed to poorly managed business risk (such as that created by a poorly performing management team).

Venture capital has traditionally posed few of these financial instability risks. While differences naturally exist in how venture capital investments are structured, there nevertheless remain hallmarks of traditional venture capital finance which are reflected in the rule-making pursuant to Section 407 of the Act. These hallmarks include, among other things, an investment portfolio

\(^3\) 156 Cong. Rec. S5905 (July 15, 2010).
\(^4\) ibid.
\(^5\) See, e.g., comments of Representative Anna Eshoo, at 156 Cong. Rec. E1295 (July 13, 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.’”)
consisting of equity securities in private firms, the absence of any meaningful leverage at such firms, an unleveraged capital structure at the fund, and no ability of fund investors to redeem their fund investments. Again, stated in terms of basic corporate finance theory, the result is an investment that is potentially high in \textit{business risk} but not with respect to \textit{financial risk}. This is critical to bear in mind when assessing the risk/return profile presented by venture capital investments compared to that presented by a private equity investments.\(^7\)

Second, a cursory look at the extended history of banks’ investment in venture capital confirms the conclusion that their participation in venture capital finance has posed little risk of jeopardizing banks’ overall stability. Both prior to and subsequent to the enactment of the Gramm-Leach-Bliley Act in 1999, bank holding companies regularly made passive limited partnership investments in venture capital funds under the general authority provided by Sections 4(c)(5) and 4(c)(6) of the Bank Holding Company Act of 1956.\(^8\) By 1999, Chase, FleetBoston, Wells Fargo, J.P. Morgan, and First Union alone reported an aggregate investment of over $5 billion in venture-capital investments.\(^9\) Notwithstanding the collapse of the dot-com economy after 2000, however, these banks showed no notable signs of financial distress—a telling indicator of the ability of banks to manage the business risks associated with venture capital investments. This conclusion appears all the more apt in light of the fact that regulatory capital requirements at the time required banks to hold only 4 cents of their own equity capital for every dollar invested in venture capital.\(^10\) Congressional testimony offered in June 2000 by Federal Reserve Governor Laurence Meyer indicated that banks were nonetheless holding significant...

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\(^7\) See Alexander Peter Groh and Oliver Gottschalg, The Opportunity Cost of Capital of US Buyouts (2009), IESE Research Papers D/780, available at \url{http://www.iese.edu/research/pdfs/DI-0780-E.pdf} (emphasizing the need to separate analysis of the risk-characteristics of venture capital and buyout asset classes owing to the existence within the latter of both operating risk and leverage risk).

\(^8\) Under Section 4(c)(6) of the Bank Holding Company Act and existing Federal Reserve regulations, a bank holding company or a nonbank subsidiary is authorized to invest in the securities of a nonbanking company if the investment (i) represents 5 percent or less of each class of voting securities of the nonbanking company, (ii) represents less than 25 percent of the total equity of the nonbanking company; and (iii) is otherwise noncontrolling. Additionally, under the provisions of Section 4(c)(5) of the Bank Holding Company Act, a bank holding company may acquire securities of nonbank companies “which are of the kinds and amounts eligible for investment” by national banks. Pursuant to section 302(b) of the Small Business Investment Act of 1958, a national bank may invest in stock of small business investment companies (SBICs) subject to certain restrictions. As discussed below, SBICs effectively function as venture capital funds by using a combination of private capital and funds borrowed with a guarantee by the Small Business Administration. Consequently, bank holding companies have long been permitted to make passive investments in venture capital through direct investments in venture capital funds under Section 4(c)(6) and direct investments in SBICs under Section 4(c)(5).


\(^{10}\) See Testimony Before the Subcommittee on Securities and the Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, June 7, 2000 (statement of Laurence H. Meyer), available at \url{http://www.federalreserve.gov/boarddocs/testimony/2000/20000607.htm}. Capital requirements for nonfinancial equity investments were raised following the Gramm-Leach-Bliley Act. See 12 CFR 225, App A. [hereinafter Meyer Testimony]
capital against these positions,\footnote{capital against these positions,\footnote{See Meyer Testimony, supra note 10.}} no doubt on account of the widely-known business risks associated with such investments.

The transparent and open risks posed by venture capital may also account for the absence following the collapse of the dot-com market of any “bailouts” of under-performing venture capital funds by banks or financial services firms. As noted above, investments in venture capital funds are typically non-redeemable, requiring investors to make a long-term commitment to the fund and its associated investment risks. Consequently, a poorly performing venture capital fund poses little risk of the \textit{de facto} bank runs by investors that caused firms such Citigroup and Bear Stearns in 2007 to rescue their sponsored investment pools that were exposed to deteriorating subprime assets.

Additionally, there is also reason to believe that banks’ investments in venture capital may also contribute to financial stability in a more positive and direct fashion than simply avoiding financial instability. With respect to individual banking institutions, a study of banks’ role in the venture capital market over the period 1980–2000 found that banks’ venture investments strengthened their capacity to lend to target companies, presumably on account of the greater information a bank is able to ascertain regarding a prospective borrower’s creditworthiness and business prospects. The same study also suggested that companies benefit through lowered cost of borrowing, suggesting positive spill-over effects on the local economy as whole.\footnote{Thomas Hellman, Laura Lindsey, Manju Puri, “Building Relationships Early: Banks in Venture Capital,” NBER Working Paper No. 10535 (June 2004).} Indeed, to the extent “financial stability” refers to activities that promote fundamental economic growth—an approach to understanding financial stability for which there is broad support\footnote{See, e.g., Michael Foot, Managing Director, U.K. Financial Services Authority, “What Is Financial Stability and How Do We Get It?” (April 3, 2003) (listing employment levels at close to the economy’s natural rate as one of the four key elements of financial stability); Garry J. Schinasi, “Defining Financial Stability,” WP/04/187, IMF Working Paper (October 2004), page 8 (focusing on the overall performance of an economy, including the efficient allocation of resources and the effectiveness of economic processes such as wealth accumulation, economic growth, and social prosperity).}—banks’ ability to participate in and expand the venture capital financing market would easily satisfy this metric. A leading study of venture capital, published in 2011, found that:

- Companies that had received venture capital backing employed approximately 12 million people and generated more than $3 trillion in revenues – or, in other words, represented 11% of private sector employment and the equivalent of 21% of U.S. GDP.\footnote{IHS Global Insight, Venture Impact: The Economic Importance of Venture-Capital Backed Companies to the U.S. Economy (6th Ed.) (2011) at 2-3.}
- Venture-backed companies meaningfully outperform the overall economy in terms of revenue growth and job creation.
- Silicon Valley and similar innovation centers across the United States have formed new industries, with significant effects on American economic growth and global
competitiveness. These industries include information technology, biotechnology, semiconductors, online retailing, clean energy, social media and cloud computing.

- Venture investments yield outsized societal returns. With investments on the order of 0.1-0.2 percent of GDP, venture backed companies generate 21% of U.S. GDP.15

Finally, it is worth noting in closing that however one conceives of the “financial stability” standard set forth in Section 619(d)(1)(J), Congress’ choice to permit under Section 619(d)(1)(E) investments in Small Business Investment Companies (SBICs) would seem to support a similar exemption for traditional venture capital investments. Like traditional venture capital funds, SBICs are privately owned and managed investment funds that invest in early-stage businesses. They differ from traditional venture capital funds, however, by their ability to raise up to two-thirds of their investment capital through funds borrowed with a guarantee from the Small Business Administration. As such, SBICs arguably represent a more risky investment opportunity for their investors in light of their exposure to both the conventional business risks of early stage investing as well as the financial risks arising from their leveraged capital structure. To the extent Congress viewed venture capital investments through SBICs as not posing significant risks to financial stability, it is thus difficult to see why similar investments made through conventional (unleveraged) venture capital funds should be treated any differently. Permitting this distinction to exist may even induce venture funds to restructure as SBICs to obtain bank capital, thereby introducing a potential destabilizing distortion into the venture capital marketplace.

Please contact me if you have any questions about my comments or if I may be of further assistance in your study and rulemaking process. Thank you again for your consideration of my submission.

Ken Taymor
Executive Director

15 Venture Impact, at 2; see also U.S. Bureau of Economic Analysis.