SVB Financial Group

February 13, 2012

Jennifer J. Johnson
Secretary
Bd. of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

Submitted via www.regulations.gov

Re: Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds

Ladies and Gentlemen:

SVB Financial Group ("*SVB*") is pleased to submit these comments in response to the Agencies' joint notice of proposed rulemaking 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*").

The majority of our comments focus on the critically important question of whether the Volcker Rule should apply to venture capital funds, which is set forth in Question 310 of the joint notice. We believe it should not.

The statute gives the Agencies the discretion *and the responsibility* to refine the scope of the Volcker Rule. In the case of venture capital, the record clearly demonstrates that Congress did not intend, and does not want, the Volcker Rule to restrict the flow of capital to start-up companies – and for good reason.

Venture investments are not the type of high risk, "casino like" activities Congress designed the Volcker Rule to eliminate. They do not rely on leverage; are not interconnected with broader financial markets; do not act as a source of short-term liquidity for investors; and mature slowly, over years. Bank investments in venture capital funds bear no resemblance to short term trading, are well suited to existing safety and soundness regulation, and do not require Volcker's more rigid restrictions.

More importantly, venture capital investments fund the high-growth start-up companies that will drive innovation, create jobs, promote our economic growth, and help the United States compete in the global marketplace. In speech after speech, President Obama has made clear he recognizes that "innovation is what America has always been about," and that "most new jobs are created in start-ups and small businesses."[1] Time and again, he has reiterated this Administration's commitment to "help win the future by knocking down barriers" standing in entrepreneurs' way;[2] to rebuild an economy that is built to last; to bet on American ingenuity; to support every risk-taker and entrepreneur who aspires to become the next Steve Jobs; and to "tear down the regulations that prevent aspiring entrepreneurs from getting the financing to grow."[3]

It would be both surprising and counter-productive if the Agencies were to erect precisely the kind of barrier the President has said he wants to knock down. We believe the Agencies have a fundamental choice as they implement the Volcker Rule. They can default to a rigid, expansive interpretation of the statute, and promulgate final rules that will harm the U.S. economy. Or they can distinguish real risks from perceived risks and actively use the discretion the statute provides to craft rules that make good sense for our financial sector and for our broader economy.

In addition to clarifying that the Volcker Rule does not cover venture funds, we urge the Agencies to:

1. Clarify that employee benefit plans such as Employee Securities Companies are not prohibited from investing in covered funds;
2. Allow banking entities to value investments in customer funds at cost, to promote predictability and avoid penalizing institutions for making profitable investments;
3. Not expand the Volcker Rule to restrict merchant banking investments made "in parallel" with investments by a bank-sponsored advisory fund;
4. Clarify that the Volcker Rule does not change existing reserve requirements, and that the tier 1 capital deduction for investments in sponsored funds applies only to the aggregate 3% limits set forth in the Volcker Rule;
5. Allow funds formed prior to May 1, 2010 to qualify as advisory funds under sections 11 and 12 without having to breach pre-existing contractual and fiduciary obligations to their customers;
6. Amend the definition of "contractual obligation" under the conformance period rules;
7. Clarify that fund ownership does not include carried interest (profit sharing), regardless of whether the interest is transferable;
8. Revise its approach to proprietary trading, to avoid placing an unreasonable compliance burden on smaller and mid-size banks;

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1 President Obama, *"State of the Union Address"* (January 2012).

2 Office of the Press Secretary, *"White House to Launch 'Startup America' Initiative: Administration and Private Sector Campaigns Will Promote Entrepreneurship and Innovation"* (Jan. 31, 2011). http://www.whitehouse.gov/the-press-office/2011/01/31/white-house-launch-startup-america-initiative.

3 President Obama, *"State of the Union Address"* (January 2012).

9. Provide additional time for entities to come into compliance, in light of delays in finalizing rules; and

10. Adopt final rules only if they satisfy a properly conducted cost-benefit analysis.

BACKGROUND ON SVB FINANCIAL GROUP

SVB is a bank and 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, 2011, SVB had total assets of $20 billion.

We are the premier provider of financial services for start-up and growing companies in the technology, life science, and clean technology sectors, as well as the venture capital funds that finance their growth. Over nearly thirty years, we have become the most respected bank serving the technology industry. We 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 roughly half of the venture-backed high growth start-ups across the United States and well over half of the venture capital firms, working through 26 U.S. offices and international offices located in China, India, Israel and the United Kingdom.

We earn the vast majority of our income by providing traditional banking and financial services to our clients. Throughout the downturn, we continued to lend to our clients. We increased loans by 67% between 2007 and 2011 (from $4.2 billion to $7.0 billion), and in the past two years we have grown loans at just over three times the average rate of peer institutions.[4] Equally importantly, we maintained the highest standards for credit quality and capital and liquidity management. Our credit quality throughout the recent downturn was comparable to peer institutions at its worst and better than most peers through the recession's trough.[5] Our ability to actively lend to our clients while maintaining strong credit quality reflects our commitment to provide the credit our clients need to grow, our deep understanding of the markets we serve, and the fundamental strength of the technology sector. As one measure of our performance, Forbes Magazine recently listed SVB as one of the ten best performing banks in the United States, for the third year in a row.[6]

In addition to our core banking business, SVB (the holding company) has sponsored venture capital funds and made investments in certain third-party venture funds.

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[4] Loan amounts are period-end balances net of unearned income as of December 31, 2007 and December 31, 2011. The loan growth comparison is based on an SVB analysis, using data from the Federal Financial Institutions Examination Council ("FFIEC"), which showed that between the third quarter of 2009 and the third quarter of 2011 SVB grew its loan portfolio by 36% while peer institutions, on average, grew their loan portfolios by 11%.

[5] SVB analysis based on FFIEC data.

[6] "America's Best and Worst Banks," Forbes Magazine. 2009, 2010, 2011. Forbes' rankings are based on institutions' financial performance (return on equity), credit quality (non-performing loans as a percent of total loans and loan loss reserves as a percent of non-performing loans), and capital/liquidity strength (tier 1 ratio and leverage ratio).

Our sponsored funds, managed by our SVB Capital division, 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 eleven "funds-of-funds" that invest 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. If the Volcker Rule is applied to venture capital funds, it will limit our ability to sponsor and invest in these funds.

Our investments in third-party funds include a small number of investments in venture funds that provide loans to start-up companies, and a larger number of small investments in venture funds that provide equity to start-up companies. If the Volcker Rule is applied to venture capital funds, it will completely prohibit us from making these types of investments going forward.

All fund investments are made by the holding company (SVB Financial Group), using shareholders' capital. They are not and cannot be made by the bank, Silicon Valley Bank, and are not and cannot be made using depositors' 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 safely and soundly and in accordance with all applicable rules and regulations. If they were to conclude that our venture-related activities could negatively impact the bank or its depositors, they have authority to require us to address the problem, including the authority to issue "cease and desist" orders.

Our multi-faceted role as banker, lender, investor, and advisor to start-up companies, venture capital funds, and limited partner investors uniquely positions us to see how changes in laws and regulations may affect the vibrant ecosystem we serve. We remain extremely optimistic about the number of American entrepreneurs forming companies and the power of their ideas. However, we are deeply concerned that U.S. policy decisions are having negative, unintended consequences for continued American leadership in innovation-based economic growth.[7]

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7 *See, e.g.,* J. Haltiwanger, *"Job Creation and Firm Dynamics in the U.S."* (March 2011) at pages 13, 17 ("there is substantial evidence that the pace of business dynamism has fallen over time in the U.S.," which "raise[s] concerns about how well the U.S. is poised to recover in a robust manner" from the Great Recession); S. Shane, *"The Great Recession's Effect on Entrepreneurship,"* Federal Reserve Bank of Cleveland (Mar. 24, 2011).

In *"The Atlantic Century II: Benchmarking EU and U.S. Innovation and Competitiveness"* (July 2011), the European-American Business Council and the Information Technology & Innovation Foundation studied sixteen key indicators of innovation competitiveness across forty countries and four regions. They found the United States ranks fourth overall, and second to last in terms of progress over the last decade. "*Benchmarking U.S. Innovation"* at pages 1-2. In terms of venture capital investments, they found the United States ranked 11th (on a per capita basis), and 23rd out of 25 on progress over the past decade, with per capita venture investing falling 67.5% over that period. *Id.* at page 24. The authors concluded that "America's … major challenge is not timidity, but torpidity. Far too many in America believe that the United States has been number one for so long that it will continue to be number one regardless of whether it acts decisively." *Id.* at page 2.

DISCUSSION

I. THE VOLCKER RULE WAS NOT INTENDED TO COVER – AND SHOULD NOT COVER – VENTURE FUNDS AND INVESTMENTS *(QUESTIONS 217, 221-223, 225, 307, 309-310, 313)*

As the Financial Stability Oversight Council recognized, the question of whether the Volcker Rule should apply to venture capital investments is a "significant" issue.[8] Whether examined from a policy perspective, a regulatory perspective, a statutory perspective, or in terms of Congressional intent, we believe the answer is clear: The Agencies should continue to regulate venture capital funds and investments under traditional "safety and soundness" principles and should not subject them to the Volcker Rule's more rigid framework.

In Section I(B), we discuss the specific differences that differentiate venture capital from private equity and hedge funds, the statutory bases we believe the Agencies may use to distinguish venture capital funds, and how they can build upon the SEC's rules defining venture capital funds to achieve a sound policy outcome.

Before turning to that discussion, however, we believe it is important to address a few foundational questions. Dodd-Frank generally, and the Volcker Rule specifically, are a means to an end – not an end in themselves. They were designed to eliminate risk-taking by banking entities that can lead to a financial collapse. The Agencies have a general duty in all they do – and a particular duty in this proceeding, given the Volcker Rule's truncated legislative process and "behind the scenes" drafting – to carefully consider how to apply the statute in a way that is consistent with Congress' intent, does not harm our economy to eliminate a non-existent risk, and does not impose costs that exceed the regulations' benefits.

Deputy Treasury Secretary Wolin talked about the balance the Agencies must strike:

> "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."[9]

In order to achieve this balance, the Agencies need to understand the role venture investing plays in innovation and economic growth, the impact a broad interpretation of the Rule could have on start-up funding, the true risk profile of venture investing, and the extent to which venture investments can be effectively regulated outside the Volcker Rule. We therefore discuss these questions before addressing the specific statutory language.

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8 Financial Stability Oversight Council, *"Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds,"* (January 2011) at page 62.

9 Deputy Secretary Neil Wolin, "*Remarks at Georgetown University,"* (Oct. 25, 2010), *available at* http://www.treas.gov/press/releases/tg923.htm.

A. *Why Volcker Should Not Govern Venture Investments*

1. *Venture Capital Investments Make Significant Contributions to U.S. Economic Growth, Job Creation, and Global Competitiveness*

SVB discussed the impact venture capital investing has on the U.S. economy in detail in its comments to the Financial Stability Oversight Council.[10] We will not repeat that discussion in these comments, but offer the following highlights.

Venture's direct impact on jobs and GDP. As a recent study concluded, "at every stage of [a] firm's life cycle – at birth, at the time of VC financing, and beyond – on average VC-financed firms persistently tend to be an order of magnitude larger than non-VC financed firms, as measured by employment and sales."[11] Quite simply, venture-backed companies grow fast, create jobs, and provide outsized returns to our economy.

A number of studies have shown that high growth young businesses – including those funded by venture capital – are the principal source of both net and gross new job creation in the United States.[12]

Studies by the firm IHS Global Insight have consistently documented the specific link between venture-backed companies and employment growth. In its most recent study, IHS found that, as of 2010, companies that had received venture funding employed 11.9 million people -- approximately 11% of all U.S. private sector workers – and out-performed the broader economy during the recent financial downturn.[13] Other studies have confirmed venture's meaningful contribution to job creation.[14]

Not only do venture-funded companies create a meaningful share of total U.S. employment, they create good, high paying jobs – the kind of higher skilled, higher wage jobs

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10 Letter from SVB Financial Group to the Financial Stability Oversight Council, *"Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds,"* File No. FR Doc. 2010-25320 (November 5, 2010) at pages 11-17 (hereinafter, "*SVB FSOC Comments*").

11 M. Puri and R. Zarutskie, "*On the Lifecycle Dynamics of Venture-Capital- and Non-Venture-Capital-Financed Firms,"* (June 2010) at page 3, *available at* papers.ssrn.com/sol3/papers.cfm?abstract=967841.

12 *See "Job Creation and Firm Dynamics in the U.S."* at pages 4, 8, 10 (young firms are an important source of job creation, have higher productivity levels and higher productivity gains than more mature establishments, and are among the fastest growing firms in the economy); J. Haltiwanger, R. Jarmin, J. Miranda, *"Who Creates Jobs? Small vs. Large vs. Young"* National Bureau of Economic Research, NBER Working Paper No. 16300 (2010) at page 3, *available at* http://www.nber.org/papers/w16300; L. Klapper and I. Love, *"The Impact of the Financial Crisis on New Firm Registration,"* World Bank Dev. Research Group, Fin. and Private Sector Dev. Team, Policy Research Working Paper 5444 (2010) pages 2-3, *available at* http://www.wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2010/10/12/000158349_20101012085129/Rendered/PDF/WPS5444.pdf.

13 IHS Global Insight/National Venture Capital Association, "*Venture Impact: The Economic Importance of Venture-Backed Companies to the U.S. Economy"* (2011), *available at* www.nvca.org.

14 *See* notes 22-23.

needed to restore job growth to the rates seen in the 1990s and mitigate increasing income disparities within the U.S. workforce.[15]

In contrast, a recent study of private equity/buyout funds found that buyouts destroy jobs at target firms and, more broadly, have a modestly *negative* impact on employment.[16]

Similarly, while annual venture capital investments are only approximately 0.1 – 0.2 percent of U.S. GDP and the number of venture-backed companies is very small, venture-backed companies in 2010 generated $3.1 trillion in revenues, or 21% of U.S. GDP.[17] As with employment, venture-backed companies increased their shares of U.S. revenues and outperformed the broader economy during the 2008-2010 downturn.[18] For every dollar of venture capital invested over the past 40 years, venture-backed companies generated $6.27 of revenue in 2010 alone.[19]

Venture-funded companies are also meaningfully more likely to go public than their peers.[20] The capital provided through an IPO can be used to fuel future growth and, as a result, the most significant levels of job creation occur post-IPO.[21]

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15 *See, e.g., "On the Lifecycle Dynamics of Venture-Capital- and Non-Venture-Capital-Financed Firms,"* at pages 15, 16 (venture-backed companies spend a much larger share of sales on payroll expenses; in addition to hiring more employees, they pay their employees higher wages relative to sales than their peers); Information Technology & Innovation Foundation, *"Innovation Policy on a Budget: Driving Innovation in a Time of Fiscal Constraint"* (Sept. 24, 2010) at page 2 (discussing the need to move from low-skilled, low-wage jobs to higher skilled, higher wage jobs in order to restore job growth to the rates seen in the 1990s).

16 S. Davis, J. Haltiwanger, R. Jarmin, J. Lerner, and J. Miranda, *"Private Equity and Employment"* (Aug. 24, 2011), *available at* http://ssrn.com/abstract=1919055. The study examined U.S. private equity transactions from 1980 to 2005. It tracked 3,200 target firms and their 15,000 establishments before and after their acquisition by a private equity/buyout fund, comparing outcomes to controls similar in terms of industry, size, age, and prior growth. The study distinguished private equity/buyout firms from venture capital firms, because the "controversy [over whether PE buyouts reduce jobs] involves buyouts and other later-state private equity transactions, not venture capital." *Id.* at pages 1-2. In terms of its specific findings, the authors concluded that employment at companies acquired by PE/buyout funds declined 3% compared to peer companies over two years post-buyout and 6% over five years. Target firms, however, create new jobs at new establishments and acquired and divested establishments more rapidly. When the authors considered these broader effects, net relative job losses at target firms was less than 1% of initial employment.

17 *"Venture Impact"* at pages 2-3; *see also" On the Lifecycle Dynamics of Venture-Capital- and Non-Venture-Capital-Financed Firms"* at page 2 (venture-financed firms are an extremely small percent of all new firms).

18 *"Venture Impact"* at page 2.

19 *"Venture Impact"* at page 2.

20 *"On the Lifecycle Dynamics of Venture-Capital- and Non-Venture-Capital-Financed Firms"* at page 19 (after five years, 5.3% of venture-backed firms have gone public (compared to 0.01% of peer companies); after ten years, 7.6% of venture-backed firms have gone public (compared to 0.01% of peer companies)); S. Kaplan and J. Lerner, *"It Ain't Broke: The Past, Present, and Future of Venture Capital"* (Dec. 2009) at page 3 (a large fraction of IPOs, including the most successful, are VC funded; since 1999, over 60% of IPOs have been VC-backed).

21 Thomsen Reuters/National Venture Capital Association, *"Yearbook 2011"* at page 8, *available at* www.nvca.org (citing a 2009 study by IHS Global Insight finding that over ninety percent of job creation by venture-backed companies occurred post-IPO).

Study after study has confirmed the role venture capital plays in promoting innovation, job creation, and economic growth.[22]

Studies have not only examined the overall impact venture has on the economy, they have specifically examined the role early stage investors play in helping funded companies make the contributions to employment, GDP, growth, innovation, and other societal "goods" discussed in this section.[23] For example, a 2011 study investigated whether venture firms contribute to

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[22] *See, e.g., "On the Lifecycle Dynamics of Venture-Capital- and Non-Venture-Capital-Financed Firms"* at page 2-3, 12, 15-16 (venture-backed firms grew employment approximately four times as fast as non-venture backed companies during their first five years, and even more rapidly thereafter, and experienced a similar pattern in revenue growth; as of the early 2000s companies that had received venture financing accounted for 5% - 7% of U.S. employment and these firms' share of employment had risen steadily from 2.8% in the 1980s); B. Jain and O. Kini, *"Venture Capitalist Participation and the Post-Issue Operating Performance of IPO Firms,"* Managerial and Decision Economics Vol. 16 (1995) at pages 593-606 (firms financed by venture capital grow faster in both sales and employment); A. Belke, R. Fehn, N. Foster, *"Does Venture Capital Investment Spur Economic Growth?,"* CESifo Working Paper No. 930 (Apr. 2003) at pages 1, 3, 4, *available at* papers.ssrn.com/sol3/papers.cfm?abstract_id=400200 (comparing the relative performance of Anglo-Saxon countries in the 1990s to Germany and Japan, concluding that "[v]enture capital is crucial for financing structural change, new firms and innovations," and warning that "[c]ountries with a rigid set of institutions that tend to stifle innovative entrepreneurship are … likely to fall behind in terms of economic development as reflected in growth per capita GDP and of employment"); EU Staff Working Paper, D.G. Internal Market and Services, *"A New European Regime for Venture Capital,"*(Oct. 2011) at pages 2, 5, *available at* ec.europa.eu/internal_market/consultations/2011/venture_capital.en.htm (venture capital helps drive innovation, economic growth and job creation and has a lasting effect on the economy as it mobilizes stable investment); OECD Discussion Note, *"Promoting Longer-Term Investment by Institutional Investors: Selected Issues and Policies,"* (Feb. 2011), at pages 1-2, 10, 12, *available at* www.oecd.org/dataoecd/37/42/48281131.pdf (discussing venture capital's role in driving competitiveness, supporting economic growth, increasing productivity, reducing costs, diversifying means of production, and creating jobs); T. Meyer, *"Venture Capital Adds Economic Spice," Deutsche Bank Research (*Sept. 14, 2010) (finding that an increase in venture investments is associated with an increase in real GDP and that the impact of early-stage investments in SMEs has an even more pronounced impact on real economic growth); S. Kortum and J. Lerner, *"Does Venture Capital Spur Innovation?,"* NBER Working Paper 6846 (Dec. 1998), *available at* http://www.nber.org/papers/w6846 (examining the influence of venture capital on patented inventions in the United States across twenty industries over three decades and concluding that the amount of venture capital activity in an industry significantly increases its rate of patenting); *see also* McKinsey Global Institute, *"An Economy that Works: Job Creation and America's Future"* (June 2011) at page 8, *available at* http://www.mckinsey.com/mgi/publications/us_jobs/pdfs/MGI_us_jobs_full_report.pdf (discussing the important role venture capital and other forms of financing for start-ups and growing young companies needs to play in a broad-based jobs agenda); W. Kerr, J. Lerner, A. Schoar, *"The Consequences of Entrepreneurial Finance: Evidence from Angel Financings"*, Working Paper, Harvard University and MIT (2011), *available at* www.edegan.com/wiki/index/php/Kerr_Lerner_Schoar_(2011)_The_Consequences_Of_Entrepreneurial_Finance_Evidence_From_Angel_Financings (studying the role of early stage investors – in particular, angel investors – on start-ups' success); *see generally* G. Filipov, *"Does Venture Capital Contribute to the Success of Startups? A Literature Review"* (July 2011) (summarizing existing literature on the relationship between venture capital and start-up firms' growth, innovation, and initial public offerings).

[23] *See, e.g., "It Ain't Broke"* at page 2-3 (VCs improve the outcomes of and add value to their portfolio companies by monitoring and aiding companies after they invest); M. Petreski, *"The Role of Venture Capital in Financing Small Businesses"* (2006), *available at* http://ssrn.com/abstract=906876 (the role of venture in financing small business is tremendous because venture investors provide much more than just capital, including monitoring, skills, expertise, help, and the reputation to attract further finance); J. Lerner, *"Boom and Bust in the Venture Capital Industry and the Impact on Innovation,"* (2002) at pages 11-12, 13, *available at* http://ssrn.com/abstract_id=366041 (discussing the ways in which venture funds eliminate asymmetries

economic growth and entrepreneurship – as opposed to simply selecting the most promising start-ups and substituting their financing for other forms of capital the companies otherwise would have used. The authors concluded that "increases in the supply of venture capital positively affect firm starts, employment, and aggregate income" through two mechanisms: by encouraging would-be entrepreneurs to start firms, and by transferring know-how from funded firms to their employees, thereby enabling spin-offs.[24] Similarly, a 2003 study found that the involvement of venture capitalists improved the survival profile of IPO firms[25] and a recent study of very early stage "angel" investors found that funded firms are 25% more likely to survive for at least four years than peer companies, are 11% more likely to undergo a successful exit (IPO or acquisition), are 16% more likely to be generally successful (reaching a successful exit or reaching at least 75 employees), and are 18% more likely to have a granted patent.[26]

Venture's direct impact on economic growth and global competitiveness. Venture-funded companies create entire new industries that have a meaningful, long term impact on the U.S. economy and the United States' competitiveness in global markets.[27] In the words of the leading study of venture's impact, "Venture has proven itself to be the most effective mechanism for rapidly deploying capital to the most promising emerging technologies and industries – moving nimbly to where future opportunities lie."[28] Its long-lasting impact can be seen by looking at the share of total employment and revenues venture-financed companies account for in key sectors of our economy: [29]

Sector	% of Total Employment	% of Total Revenues
Software	90%	40%
Biotechnology	74%	80%
Semiconductors/Electronics	72%	88%
Computers	54%	46%

between entrepreneurs and investors and structure investments, describing venture capital as "the dominant form of equity financing in the U.S. for privately held high-technology businesses," and concluding that venture funding has a "strong positive impact on innovation").

24 S. Samila and O. Sorenson, *"Venture Capital, Entrepreneurship, and Economic Growth,"* The Review of Economics and Statistics Vol. 93, Issue 1, at pages 338-349, 347 (Feb. 2011).

25 B. Jain and O. Kini, *"Does the Presence of Venture Capitalists Improve the Survival Profile of IPO Firms?,"* Journal of Business Finance & Accounting, Vol. 27, Issues 9-10 (Nov./Dec. 2000) at pages 1139-1183.

26 *"Consequences of Entrepreneurial Finance"* at pages 5, 23-24. In sum, the authors concluded, In sum, these companies hire more employees, grow faster as measured through web traffic performance, and are better financed than their peers.

27 *See, e.g.,* A. Popov, *"Does Finance Bolster Superstar Companies? Banks, Venture Capital, and Firm Size in Local U.S. Markets,"* European Central Bank Working Paper Series No. 1121 (Dec. 2009), *available at* www.ecb.int/pub/pdf/scpwps/ecbwp1121.pdf. This paper compared the relative contribution of bank deregulation and the emergence of the venture capital industry on the emergence of U.S. corporate giants. The authors consistently found a "significant positive effect" of venture capital finance. Not only did firms with 100+ employees grow larger in states with higher VC investment, venture investing affected the real economy by creating new firms and promoting economic growth through disruptive innovation. *See also "It Ain't Broke"* at page 3 (venture capital has fueled many of the most successful start-ups of the last thirty years, including four of the twenty companies with the highest market capitalization in the United States and a large number of other highly valuable companies).

28 *"Venture Impact"* at page 1.

29 *"Venture Impact"* at page 9.

Venture-backed companies include a long list of household names—from Facebook, 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.

Venture's broader effects on economic growth. Venture-funded companies have positive second-order effects on the U.S. economy – by giving U.S. firms a "first mover" advantage, thereby expanding exports and employment; by creating a "virtuous cycle" in which disruptive innovation causes new industries to expand, which in turn leads to broader economic growth and increased job creation in supporting industries; and by increasing productivity, leading to wage increases, price declines, and greater economic activity.[30] A 2004 study by the Milken Institute, for example, found that every job created within biopharmaceuticals creates an additional 6.7 jobs in other sectors.[31] In addition, venture-funded companies serve as a pipeline that helps larger, more mature firms continue growing.[32]

Venture's impact on innovation. Increases in venture capital activity are associated with significantly higher patenting rates.[33] According to one study, "a dollar of venture capital appears to be about three times more potent in stimulating patenting than a dollar of traditional corporate R&D."[34] The patents created are high quality: according to the same study, they were more frequently cited by other patents and were more aggressively litigated.[35]

Venture's impact on society and social challenges. Innovation plays a central role in improving citizens' quality of life by expanding access to information, providing higher quality goods and services, improving health care quality and access, and fostering a more sustainable environment. Virtually the entire biotechnology industry and most of the significant

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30 *See, e.g., "Venture Capital, Entrepreneurship, and Economic Growth"* at page 348 (venture's direct effects "almost certainly underestimate the total economic value of venture capital," since "much of the value created by the most successful firms spills over to other regions" by improving productivity and leading to broader-based job growth)*; "Innovation Policy on a Budget"* at page 2.

31 Milkin Institute, *"Biopharmaceutical Industry Contributions to State and U.S. Economies* (Oct. 2004).

32 *"It Ain't Broke"* at page 2 (corporate innovation has increasingly moved from large, centralized research facilities to various "open innovation" models, including acquisitions and strategic alliances with smaller firms such as those backed by venture capitalists); *"On the Lifecycle Dynamics of Venture-Capital- and Non-Venture-Capital-Financed Firms"* at page 19 (after five years, 17.8% of venture-backed firms have been acquired, versus 0.6% of their peers; after ten years, 23.8% of venture-backed firms have been acquired, versus 0.8% of their peers); National Venture Capital Association, *"Patient Capital: How Venture Capital Investment Drives Revolutionary Medical Innovation"* (2007) at page 4 (over the 2002-2007 period, mature healthcare companies acquired almost 200 venture-backed life sciences companies for their innovations); M. Dent, *"A Rose by Any Other Name: How Labels Get in the Way of U.S. Innovation Policy,"* Berkeley Business Law Journal Vol. 8, No. 2 (2011) at pages 138-140 (discussing the increasing importance of the venture-backed innovation sector in driving corporate growth).

33 S. Kortum and J. Lerner, *"Assessing the Contribution of Venture Capital to Innovation,"* RAND Journal of Economics, Vol. 31, No. 4 (Winter 2000) at page 674. This study explored twenty industries covering the U.S. manufacturing sector over a three-decade period.

34 *"Assessing the Contribution of Venture Capital to Innovation"* at page 675. Specifically, the authors found that venture-funded companies' share of all industrial innovations (8%) substantially exceeded venture's share of total corporate R&D (3%).

35 *"Assessing the Contribution of Venture Capital to Innovation"* at page 675.

breakthroughs in the medical devices industry, for example, would not exist without the support of the venture capital industry, and more than one in three Americans has been positively affected by an innovation developed and launched by a venture-backed life sciences company during the past 20 years. [36]

2. ***Restricting Banking Entities' Ability to Sponsor and Invest in Venture Funds Will Hurt the Innovation Economy***

Some acknowledge the importance of venture capital but argue that banks can be excluded from investing in this sector without materially affecting the flow of capital to start-ups or the overall health of the U.S. innovation sector. This ignores several important facts.

First, banking entities are an important source of capital for start-up companies. The research firm Preqin estimates that 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.[37] At a rough order of magnitude, preventing banks from investing in venture thus could depress U.S. GDP by roughly 1.5% (or $215 billion annually) and eliminate nearly 1% of all U.S. private sector employment over the long term.[38]

Second, many bank-sponsored funds include mostly third party capital. Limiting banking entities' ability to sponsor venture funds could therefore reduce the amount of capital flowing to start-up companies by an even greater amount and deprive these investors of access to top tier venture funds.

Third, there is no reason to believe that other investors will step forward to replace banking entities' capital. Venture fundraising remains at somewhat low levels compared to historical patterns. In fact, U.S. venture funds are not currently raising enough new capital to maintain existing levels of investing.[39] In addition, the relative share of venture capital being invested in the United States is declining, and is expected to continue to decline.[40] If state and

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36 *"Patient Capital"* at pages 3, 4, and 10.

37 Preqin Ltd., *"The Venture Capital Industry: A Preqin Special Report"* (Oct. 2010) at page 9. These figures almost surely underestimate the impact of banking entities (as defined in the Volcker Rule) exiting this industry, since this study distinguishes banks from other investors, such as insurers and asset managers, that also may be subject to the Volcker Rule because they are affiliated with an insured depository institution.

38 These approximations are based on the data cited above regarding venture's contributions to U.S. GDP and private sector employment (21% and 11%, respectively), multiplied by the approximate percent of venture capital provided by banking entities (7%).

39 Thomson Reuters/National Venture Capital Association, *"Venture Capital Firms Raised $5.6 Billion in Fourth Quarter, as Industry Continued to Consolidate in 2011"* (Jan. 9, 2012) at page 2. Several submissions in this proceeding highlight the problem, and how it will be exacerbated if banking entities are precluded from investing in venture funds. *E.g.*, Letter from River Cities Capital Funds (Feb. 2, 2012) (venture capital historically has been very scarce throughout the center of the country and has contracted 80-90% over the last few years); Letter from Advanced Technology Ventures (Feb. 8, 2012) (potential restrictions on investments by bank affiliates are "particularly troubling because investments in this asset class are already constrained by decreased allocations from pension funds and endowments").

40 In 2000, funds focused outside North America raised only 25% of total global venture capital. By 2008, this had increased to 37%. *"The Venture Capital Industry: A Preqin Special Report"* at page 3. A 2010 survey by Deloitte and Touche LLP of investing professionals found that most investors believe these trends will continue. 92% of those surveyed expect the number of U.S. venture firms will decrease and 72% expect the number of

local governments meaningfully reduce the size of defined benefit pension plans, that will further erode the capital base for venture funds.

Now is a particularly bad time to restrict the flow of capital to start-ups. We remain trapped in an economy struggling to revive itself, with a jobless rate high above normal levels. The technology sector is proving to be one of the relatively few bright spots in the economy.[41] Over the longer term, start-ups are innovating in the very areas we need new solutions if we are going to be able to provide affordable health care to an aging population, supply sustainable, cost-effective energy to U.S. homes and businesses, address cyber- and national security challenges, and maintain an acceptable balance of trade. Starving the very companies that will create jobs and solve systemic problems of the capital they need, hoping that other investors will fill the void, is a very high risk strategy.

In addition to these direct effects, applying the Volcker Rule to venture investments will have several other negative consequences.

First, institutions like SVB are an important part of a broader ecosystem and contribute more than just capital to that system. Over the years, we have made small investments in hundreds of funds, often run by emerging managers. Our willingness to make investments in these funds, based on our knowledge of the fund managers' overall experience and expertise, helps the fund attract other investors. These investments also help SVB remain an effective lender to new funds and the start-ups they fund, by letting us stay abreast of emerging trends and understand the evolving dynamics of new funds. Since Volcker bans any investment in third party funds, if Volcker applies to venture, all this activity will come to a complete halt.

Second, in a handful of cases, we have worked more closely and made larger investments in new funds that provide loans (rather than equity) to start-up companies. While "larger" by venture standards, these investments are comparable in size to individual loans – not "large" in the Wall Street sense.[42] In these cases, our investments have meaningfully contributed to the funds' success *and* augmented the total supply of credit financing to high growth start-ups.[43] At

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U.S. venture investments will decrease. In contrast, more than 85% of respondents predict the number of venture firms and venture investments will increase in China, Brazil, and India. The respondents also said they see a direct correlation between current trends in venture investing and the long term dominance of the U.S. technology sector, and an important and growing link between government policies and the strength of the U.S. venture and entrepreneurial sectors. Deloitte and Touche LLP, *"2011 Global Trends in Venture Capital: Outlook for the Future"* (July 28, 2010). A large number of submissions in this proceeding address the increasing share of global venture capital moving to offshore investments, and the global competition for venture funds and investments.

[41] During 2011, for example, Silicon Valley added 42,000 jobs – a 3.8% increase, compared to 1.1% job growth for the country more broadly. S. Musil, *"Silicon Valley Economy Recovering Faster than Nation"* (Feb. 7, 2012), *available at* news.cnet.com. -

[42] These funds include Gold Hill and Partners for Growth. At September 30, 2011 (the last date for which we have publicly reported these figures), the carrying value of our investments in the two Gold Hill funds were \$16.8 and \$16.4 million, and the carrying value of our investments in the Partners for Growth funds were \$3.6 million and less than \$1.0 million. To put this in context, as of December 31, 2011, we had \$2.2 billion in outstanding loans greater than \$20 million.

[43] *See* Letter from Gold Hill Capital (Feb. 6, 2012); Letter from Partners for Growth Managers LLC (Feb. 8, 2012).

the same time, they have allowed us to manage our credit risk more effectively. Yet again, if Volcker applies to venture, we would no longer be able to help create this type of fund.

Third, SVB is not the only banking entity that works with venture investors. In some cases, banking entities share a geographic focus with a fund; in others they share sector expertise. If Volcker applies to venture, this activity will also stop – both the investments, and the broader alignment between the funds and banking entities with complementary expertise.[44]

Finally, because the Volcker Rule applies broadly to affiliates of banking entities, it could end up restricting investments by large, non-bank corporations that happen to have a small banking affiliate, such as a customer financing group. As above, this could have a direct and very negative impact, particularly in parts of the country where venture capital is less available.[45]

In the end, private investors will determine the overall supply of venture capital, and individual entrepreneurs will decide how many start-ups get created. That said, policy matters.[46] If the Agencies apply the Volcker Rule to venture capital investments, they will artificially – and we believe unnecessarily – preclude an entire industry from supporting high growth start-ups. Candidly, we hope those who claim that others will step in to fill the void are right. Unfortunately, we see no basis for such an assertion. We believe that if this Administration wants to ensure that the United States retains its position at the center of innovation, policymakers should avoid imposing restrictions that artificially restrict the flow of capital into venture capital funds and, through these funds, into America's start-ups.[47]

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[44] *See, e.g.*, Letter from River Cities Capital Funds (Feb. 2, 2012); Letter from Physic Ventures (Feb. 7, 2012).

[45] *See* Letter from Christopher L. Rizik, Renaissance Venture Capital Fund.

[46] *See, e.g., "The Impact of the Financial Crisis on New Firm Registration,"* at 2-3, 20-21, 22 (World Bank study finding that regulatory policies and access to capital are among the handful of factors that most strongly influence the level of new business formation).

[47] The paper *"The Decline of an Innovative Region: Cleveland, Ohio, in the Twentieth Century"* by Naomi Lamoreaux and Margaret Levenstein provides an illuminating view into the potential impact that economic forces, combined with regulatory changes, can have on an innovation economy. Professors Lamoreaux and Levenstein studied patenting and the commercialization of patents in Cleveland, Ohio in the post-WWI period. At the turn of the century, Cleveland was a center of technological innovation and an important entrepreneurial center. A hundred years later, "it exemplifie[d] the problems of deindustrialization, population decline, and entrenched poverty faced by many Midwestern cities." The authors conclude that the impact of the Great Depression was likely compounded by "the destruction of the complementary financial institutions that had supported entrepreneurial ventures in the region" and "changes in the regulatory regime that … made it difficult for regional capital markets like Cleveland's to recover their earlier vibrancy." The authors conclude that in light of the severe shocks felt by the U.S. economy during the recent (2008) financial crisis, it is important to understand the effects these factors can have on innovative regions like Silicon Valley. N. Lamoreaux and M. Levenstein, *"The Decline of an Innovative Region: Cleveland, Ohio, in the Twentieth Century"* (Sept. 12, 2008), at page 1, 27-28, available at www.econ.yale.edu/faculty1/lamoreaux/Decline-08.pdf.

Similarly, Professor Josh Lerner of Harvard studied the supply of venture capital before and after the Department of Labor clarified the "prudent man" rule under the Employee Retirement Income Security Act in 1979. He concluded: "The willingness of investors to provide capital before the clarification of ERISA policies looked like the supply curve may have been distinctly limited: no matter how high the expected rate of return for venture capital was, the supply would be limited to a set amount." *"Boom and Bust"* at page 3. Just as allowing pension funds to begin investing in venture released a new supply of capital and moved the capital supply curve up, prohibiting banking entities from investing in venture may restrict an existing source of capital and move the capital supply curve down, reducing investment at all rates of return.

3. *Volcker's Purpose Is Unrelated to Venture's Attributes*

According to Sens. Merkley and Levin, the Volcker Rule was "designed to protect the financial system by targeting proprietary trading at banking entities and systemically significant nonbank financial companies, while allowing those firms to continue to engage in client-oriented, risk-reducing, or other traditional banking activities that facilitate the formation and deployment of capital."[48]

In their article, the Senators present the view that deregulation allowed large commercial banks to "amass[] enormous proprietary trading positions in increasingly complex and risky assets."[49] Individual institutions developed trading accounts that measured in the hundreds of billions of dollars and then used high levels of leverage, increasingly complex products, and increasingly complex and risky trading strategies to increase their returns – and, unfortunately, their risks.[50] In addition, the authors assert, banks moved to a "traders first, clients last" mentality that gave rise to "egregious" conflicts of interests with clients.[51] When the financial crisis hit, some of these highly leveraged investments began to sour, which called into question the value of other similarly risky holdings – leading to write-downs, massive losses (measured in the hundreds of billions of dollars), eroded capital positions, and ultimately a loss of confidence by investors in the firms' solvency and stability and a spreading, increasingly intense downward spiral.[52] The rest, as they say, is history.

In the case of funds, the authors assert that restrictions on investing in and sponsoring private funds are needed for three reasons: to "mitigate systemic risk," to "prevent evasion of the proprietary trading provisions," and "to reduce the risk that banking institutions will bail out clients in a failed fund it sponsored or managed."[53]

When one compares venture capital to these objectives, the gap between what the provision was designed to do and the reality of what venture is (and isn't) becomes obvious.

Venture funds, by definition, "facilitate the formation and deployment of capital" – something the authors said they wanted to preserve, not eliminate.[54] When a banking entity sponsors a venture fund, it aggregates capital from third parties and invests that capital on a long

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48 Senators Jeff Merkley and Carl Levin, *"The Dodd-Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats,"* 48 Harvard Journal on Legislation at 516, 539 (2011). We do not believe that Senators and Merkley have a monopoly on defining Congress' intent in adopting the Volcker Rule. However, since they are advocates for a very broad application of the Rule, if venture does not fit even their vision of why Volcker is needed, then it certainly does fit Volcker's purposes as seen by the broader set of members who helped draft the Rule and ultimately passed Dodd-Frank.

49 *"Dodd-Frank Restrictions"* at page 520.

50 *"Dodd-Frank Restrictions"* at pages 521-22.

51 *"Dodd-Frank Restrictions"* at pages 522-23.

52 *"Dodd-Frank Restrictions"* at page 527-29.

53 *"Dodd-Frank Restrictions"* at pages 546-47.

54 *See, e.g.,* S. Kaplan and A. Schoar, *"Private Equity Performance: Returns, Persistence and Capital Flows,"* MIT Sloan School of Management Working Paper 4446-03 (Nov. 2003) at page 1, *available at* http://ssrn.com/abstract=473341 (venture funds and buyout funds play an important role "in financing and fostering innovative firms, and in reallocating capital to more productive sectors of the economy").

term basis either directly into high growth innovative companies, or indirectly in venture funds who in turn invest the funds in high growth innovative companies.

Venture funds are the antithesis of "trading," the core activity the authors said they wanted to eliminate. They make long term investments in real companies and real technologies. They mature over the better part of a decade, and both fund managers and fund investors generally realize returns only when companies successfully "exit" through a merger or public offering, not by packaging, repackaging, and trading financial instruments.

Venture funds also lack the risk factors cited by the authors: high leverage, complex products, risky trading strategies, and the capacity for losses to cascade through the system. Venture funds invest in the stock of private companies – not in public market securities, and not through derivative instruments. Venture funds typically do not use (and are not allowed under their agreements with investors to use) debt or leverage, other than very short term capital call facilities to bridge the period between when they make an investment and when their limited partners satisfy the resulting capital call.[55] In addition, venture funds do not have counter-party obligations or exposures with other funds or institutions.

Venture funds, moreover, are structured in a way that prevents conflicts of interest – another of the author's focal points. Venture fund managers earn returns principally when the companies they back succeed, rather than through fees – and, thus, are fundamentally aligned with their investors.[56] In fact, the Volcker Rule would reduce the alignment between fund managers and fund investors by restricting the extent to which a fund manager could put its capital at risk alongside investors' capital.

Venture investments, moreover, are simply too small (and too unlevered) to create the kinds of losses attributed to proprietary trading. Venture funds typically raise and invest on the order of $20-30 billion annually; in 2011, they raised $18.2 billion and invested $28.4 billion.[57] As of 2010, total capital under management by all U.S. venture funds was $177 billion,[58] and the average venture fund size was $149 million.[59] To help put that number in context, if the entire

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55 Venture funds' portfolio companies also typically use only minimal leverage and, when they borrow, it is to fund operating expenses and capital investments, not to boost returns.

56 In this respect, venture funds behave somewhat differently from PE/buyout funds, using management fees to cover costs and investment returns for upside. In *"The Economics of Private Equity Funds,"* the authors compared earnings between venture funds and PE/buyout funds. They found that venture funds earn relatively more from carried interest (*i.e.*, the value created through investments' success) while PE/hedge funds raise profits by charging more fees and raising larger funds. A. Metrick, A. Yasuda, *"The Economics of Private Equity Funds"* (July 2009) at pages 30, 32-33, 34, 36-37. According to the authors, the primary reason venture funds are less scalable is the fact that they invest in smaller companies, stay with the companies until they reach meaningful scale, and bring to bear "skills that are critical in helping firms in their developmental infancy." *Id.* at page 37.

57 *"Rounding Up: Larger Deals Driving VC Investment Increases"* (Jan. 20, 2012), *available at* http://nvcaccess.nvca.org/index.php/topics/research-and-trends/274-rounding-up-larger-deals-driving-vc-investment-increases.html; *"Venture Capital Firms Raised $5.6 Billion in Fourth Quarter, As Industry Continued to Consolidate in 2011,"* (January 9, 2012), *available at* www.nvca.org.

58 2011 Yearbook at page 9. In 2010, there were 791 VC firms in existence and 1,183 VC funds in existence. Only 157 of those funds, however, raised money during 2010.

59 National Venture Capital Association, *"Frequently Asked Questions About Venture Capital"*, *available at* http://www.nvca.org/index.php?option=com_content&view=article&id=119&Itemid=621.

venture capital sector – all 1,183 funds – were a single bank, it would only be the 17th largest bank in the United States based on asset size.[60] If all venture investments by all banking entities were aggregated, they would represent less than 0.00009% of the largest total bank assets.[61] In order for the venture sector *as a whole* to lose the amount a *single financial institution* lost during the downturn from 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.[62] And in order for the venture sector to create the kinds of losses that proprietary trading created, every single company funded by venture capital from mid-2002 through the end of 2011 would have to simultaneously and suddenly fail.[63]

If venture investments have none of the attributes of proprietary trading and are incapable of creating systemic risk, then two of the authors' three core justifications for the Volcker Rule's funds provisions do not apply to venture. The third (the risk of banking entities' bailing out fund investors) can be easily addressed using the Agencies' existing authority, rather than by imposing the entire Volcker framework on venture funds.[64]

Some who do not understand venture's true risk profile make the incorrect assumption that it is risky – and therefore inherently unsuited for regulated financial institutions. Venture investing is only risky in one sense of the term: whether it can deliver investors attractive returns to adequately compensate them for the long investment period and illiquid nature of the investments.[65] It is not particularly risky, however, in the sense that matters for purposes of this proceeding: the risk of loss of capital.

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%.[66] Over the past 28 years, venture as a class has

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60 *See* American Banker Magazine, *"Banks and Thrifts with the Most Assets,"* (Sept. 30, 2011).

61 Banking entities account for approximately seven percent of the approximately $20 billion invested annually by U.S. venture funds, or approximately $1.4 billion in annual investments. The top 50 U.S. bank holding companies had total assets of approximately $15 trillion as of September 30, 2011, so annual venture investments represent approximately 0.00009% of total assets.

62 *Compare* Stephen Gandel, *Is Proprietary Trading too Wild for Wall Street?,* Time (Feb. 5, 2010) (reporting that Lehman Brothers lost $32 billion from proprietary trading and principal transactions) *with "Annual Venture Investment Dollars Increase 22% Over Prior Year, According to the MoneyTree Report,"* (January 20, 2012) (reporting that venture capitalists invested $28.4 billion in 3,673 deals during 2011).

63 *Compare ""Dodd-Frank Restrictions"* at page 527 (by April 2008, the major Wall Street firms had suffered an estimated $230 billion in proprietary trading losses) *to "Venture Impact"* at page 5 and NVCA investment 2011 data (between 2003 and 2011, venture funds invested a total of $220 billion, and during 2002 venture funds invested $20.9 billion).

64 For example, the Agencies could require an institution that sponsors a venture fund to add disclosures in the fund offering documents making clear that the bank will not, and cannot, cover losses, and could prohibit the institution from directly or indirectly guaranteeing, assuming, or otherwise insuring the obligations or performance of the fund.

65 *See, e.g., "Private Equity Performance"* at page 28.

66 SVB Capital, *"Venture Investing is Less Risky Than You Think"* (Aug. 2010) at page 1, *available at* www.svb.com/10067/Venture_Investing_is_Less_Risky_Than_You_Think/ (citing Cambridge Associates

demonstrated limited risk of capital loss. Looking at fully mature venture funds (those funds raised prior to 1998), the venture industry returned more than the amount of invested capital in every vintage year.[67] More recent funds, which generally still hold some unrealized value, are also on track to generate positive returns for investors. The sole exception is funds raised in vintage years that were especially hard hit by the dot-com bust – especially 1998 to 2001 – but even those vintage years, which are the worst in the history of the venture industry, are still expected to generate overall industry returns of 85 to 95 cents on the dollar. Among top quartile funds, the performance is even stronger. Fully mature top performing funds have *never* failed to return capital. More recent top performing funds are solidly on track to generate positive returns for investors, and even for 1998-2001 vintage funds top performing funds are tracking towards eventual outcomes of 115 to 150 cents on the dollar, with multiple managers expected to generate additional outperformance.

Venture funds are able to achieve this performance by diversifying investments across time, stage, sector and geography, and by structuring investments to minimize the risk of capital losses.[68] In the relatively rare cases where funds do fail to return capital, the small size of funds, lack of leverage, extended period over which losses typically are realized, and limited size of each investment within a fund portfolio make these losses manageable.[69] We are aware of no case in which a banking organization has had to step in to cover losses in a venture fund.

To understand the risk of venture investing from a safety and soundness perspective, it is helpful to compare venture investing with lending. If a bank raised a moderately sized venture fund (say, $150 million) every one or two years, and contributed 10% of the capital in the fund (more than three times the Volcker Rule's limit), it would be making a $15 million investment every year or two. The returns on this investment would typically turn on the performance of five to ten companies for a direct investment fund, and on the order of 50 to 100 companies for a fund-of-funds, and would be realized over a period of a decade or more. Banks routinely make loans in the $15 million range. These loans, in contrast, mature over a much shorter period and turn on the performance of a single borrower. Thus, while venture investments are admittedly

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LLC, Dow Jones & Company, Inc., Standard & Poor's and Thomson Datastream). The fund performance data in the remainder of this paragraph is based on an SVB analysis, using Cambridge Associates data.

67 Because venture funds invest capital over an extended period and make long term investments in high growth companies, excess returns are only realized at the very end of a fund's life. Any analysis of fund performance must therefore distinguish mature funds from immature funds. *See generally "Private Equity Performance"* at pages 2-3, 13, 17, 20-21, 26-27; *"It Ain't Broke"* at pages 5-7.

68 Venture investors typically invest in preferred shares (which are senior to common stock) and have rights to liquidation preferences (a stated multiple of the investment amount that will be provided to an investor in a given financing round in the event a company is liquidated or sold). Both of these structures increase the amount venture investors receive when a company is sold or liquidated, thereby providing downside protection to investors. *"Venture Investing Is Less Risky Than You Think"* at Appendix C, *A Model of How Preferred Shares and Liquidation Preference Contribute to Protecting Venture Capital's Investors.*

69 Even for funds created 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. *"Venture Investing is Less Risky Than You Think"* at page 3.

equity investments, they have a scale, tempo, and diversified risk profile that very substantially mitigates the inherent risk of equity investments.[70]

4. *Venture Investing Is Well Suited to Traditional "Safety and Soundness" Regulation*

If the Agencies agree that, all other things equal, they prefer not to artificially restrict the flow of capital flowing to start-ups, the obvious next question is: are all other things equal? Or, in other terms, can they continue to effectively regulate venture capital investments under existing "safety and soundness" principles, without subjecting them to Volcker's more rigid framework? The answer is yes, for several reasons.

First, venture investments move at a pace that is consistent with the pace of supervision. They do not experience the kind of volatile, rapid movements that can come with investing in derivatives and public markets. Investors make investments, and those investments mature, over a period of years – not minutes or seconds.[71] Valuations change relatively infrequently, such as when a company raises additional equity from third parties. Because venture funds do not rely on leverage, potential losses can be clearly understood and assessed. And because venture funds invest almost exclusively in private companies, many of which have not grown to the stage where they have publicly traded comparables, investment values are less affected by movements in the public markets than hedge funds and private equity funds.

Second, venture's overall size, lack of interconnection, simple structure, lack of counter-party obligations, and lack of leverage mean they can be understood and effectively regulated on an institution-by-institution basis and do not require systemic solutions.

History reinforces the view that existing regulatory structures work. We are not aware of any case in which a banking entity stepped in to cover losses by an affiliated venture capital fund, or a bank failed (or even faced the risk of failure) due to losses from venture capital investing. Banking entities have been making venture investments for decades – long before Gramm-Leach-Bliley was passed – which provides further assurance that the risks and regulatory mechanisms for addressing them are well understood and well tested.

Some describe Volcker as drawing a line between lending and equity investing – forcing banks back to the former, and prohibiting the latter. That, however, is not the case. Banking entities may continue to make equity investments under Volcker.[72] At the same time, Volcker would prevent banks from lending to clients if done through a fund structure.

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70 SVB's FSOC comments discuss the inherent constraints that limit the overall size of the venture sector, the number of funds any entity can raise, and the pace at which investments are made. SVB FSOC Comments at pages 16-17.

71 Venture capital funds typically have a ten year life, and permit extensions for several additional years. Typically, initial investments in portfolio companies are made during the first two to four years, and follow-on investments are made over the following several years.

72 A bank holding company may make equity investments in individual companies under Regulation Y and the merchant banking rules. In addition, under the Volcker Rule banking entities may sponsor and invest in a fund as long as it qualifies as a small business investment company ("SBIC"). Each of these approaches is higher risk that investing in a venture fund or a venture fund-of-funds: the former because of the lack of diversification, and the latter because at least historically SBICs underperformed venture funds, possibly

B. *A Way Forward: The Agencies Should Not Subject Venture Investments to Volcker's Rigid Framework*

If the Agencies agree that artificially restricting the flow of capital flowing to start-ups should be avoided, and that venture investments can be appropriately regulated under safety and soundness principles, then the sole remaining question is: does Dodd-Frank give them the authority they need to adopt this approach? It does.

1. *The Agencies Can and Should Exclude Venture Capital Funds from the Definition of "Covered Funds"*

One of the challenges facing the Agencies is that the Volcker Rule's broad definition of covered funds is fundamentally at odds with the provision's focus on two specific types of funds (hedge funds and private equity funds) and with its overall intent (to prevent banking entities from evading the limits on proprietary trading by conducting trading through a fund structure).

The Agencies, therefore, must make a very important basic choice. They can use whatever flexibility the statute provides to refine the definition of covered funds so that it makes sense. Or they can adopt the statutory definition and then try to find a way to fix the many problems the definition's over-breadth creates.

This second approach leaves the Agencies in a difficult box. There is no reason to prohibit structures that have nothing to do with proprietary trading and the risks Volcker was designed to address, but the statute does not give the Agencies discretion to exempt activities unless they fit into one of a handful of very narrowly drafted "permitted activities."

In the proposal, the Agencies dealt with this by concluding – with no discussion or analysis – that three types of activities (bank owned life insurance separate accounts, asset-backed securitizations, and corporate organizational vehicles) promote safety and soundness and U.S. financial stability. [73] We do not believe these activities should be regulated under Volcker. But we also struggle to see how the Agencies could conclude that they meet the (d)(1)(J) test, without also concluding that venture investing meets that test.

We believe the financial system will be best served if the Agencies confront the definition's over-breadth head on, and refine the definition to capture the fund-related activities the provision was designed to reach without sweeping in other activities.

To refine the definition, we believe the Agencies should rely on the phrase "<u>or</u> such similar fund" in the definition.[74] We believe this clause gives the Agencies discretion both to

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because the selection process for SBIC licenses "appeared to emphasize political connections over investment acumen." "*Boom and Bust*" at pages 15-16.

[73] *See* Notice of Proposed Rulemaking at page 18.

[74] *See* Section 619(h)(2) ("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, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange

expand the definition's scope (as they have proposed to do with foreign funds) *and* to narrow the definition's scope (to avoid applying Volcker to funds that are neither "hedge funds" nor "private equity funds").

To decide on the proper scope, we believe the Agencies should first focus on the two types of funds Congress consistently referred to in the Volcker Rule: "hedge funds" and "private equity funds." Had Congress intended to reach all privately offered funds, it easily could have referred generally to "funds" or "privately offered funds" – just as it did in other sections of the Dodd-Frank Act.[75] It did not, a choice to which the Agencies should give weight.

We believe the Agencies should also focus on the common understanding of the terms "private equity fund" and "hedge fund." The Government Accountability Office took this approach in its study of the Volcker Rule, relying on common sense definitions for "hedge fund" and "private equity fund" rather than studying all fund structures potentially captured by the statutory definition.[76]

Venture funds are easy to distinguish from hedge funds. Hedge funds typically trade on an active basis and have a relatively short term time horizon. They most commonly trade liquid securities on public markets, though they also trade a variety of other financial instruments. They are typically open-ended, permitting investors to invest and withdraw funds at regular intervals. Some funds use aggressive investment strategies, including selling short, leverage, swaps and derivatives. Individual funds can be in the billion dollar range, and as of the third quarter of 2011 the industry as a whole had more than $1.7 trillion under management.[77] When one considers the Volcker Rule's authors' stated objectives – preventing banks from avoiding the proprietary trading ban by using a fund structure, eliminating systemically risky activities, and addressing conflicts of interest – hedge funds most closely resemble the type of fund the authors appeared to want to target.

Venture capital can also be distinguished from private equity/buyout funds. [78] They differ on a variety of fronts, including the types of companies they typically invest in (private

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Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine.") (emphasis added) (internal citations omitted).

75 *Compare* Title IV of the Act (in which Congress intended to reach a broader array of funds and therefore used the broader term "private fund.") to Section 619 of the Act (in which Congress used the much more specific terms "hedge fund" and "private equity fund").

76 *See* Government Accountability Office, "*Proprietary Trading*," GAO-11-529 (July 2011) at page 1. As the GAO noted, hedge funds "are commonly understood to be investment vehicles that engage in active trading of securities and other financial contracts" while private equity funds "are commonly understood to be funds that use leverage or other methods to invest in companies or other less-liquid investments).

77 *"Hedge Fund Industry – Assets Under Management," wwwbarclayhedge.com/research/indices/ghs/mum/HF_Money_Under_Management.html.*

78 The term "private equity" is sometimes used to refer to an entire asset class. However, within this broader asset class, commentators routinely distinguish venture capital funds from private equity/buyout funds. *E.g., "Private Equity and Employment"* at page 3 (distinguishing private equity from venture capital, and noting that the former typically acquires a controlling stake in the target firm and the transaction typically involves a shift toward greater leverage in the target's capital structure); *id.* at page 9 (noting that "most transactions that do not involve leverage are venture capital investments, rather than private equity investments in mature firms"); *"The Economics of Private Equity Funds"* at page 2, 19 (buyout funds achieve beta by purchasing low beta

high growth start-ups versus more mature publicly traded companies), their use of leverage to increase returns (which venture does not use, but PE/buyout does), their investment strategy (minority stakes, in collaboration with management in the case of venture; controlling stakes in the case of PE/buyout). In addition, PE/buyout funds manage significantly more capital than venture capital funds, and their use of leverage further increases their aggregate impact on the financial system.[79] Finally, PE/buyout funds charge more transaction fees and monitoring fees (which venture funds do not), earn substantially more per partner from fee revenues, and are much more scalable than venture funds, which translates into significant differences in fund sizes between PE/buyout funds and venture funds.[80] These attributes have been generally recognized, and many were used by the SEC to provide a clear, predictable and stable definition of a venture capital fund that can be used in this proceeding (with minor refinements), as discussed in subsection 3 below.

Starting with the common understanding of the terms "private equity fund" and "hedge fund," we believe the Agencies should decide how broadly or narrowly to define the two terms based on the provision's intent and its legislative history. If a fund does not fundamentally engage in short term proprietary trading (such that it could be used to evade the proprietary trading ban) or create systemic risk, it need not be subjected to the Volcker Rule. If the Agencies can use other regulatory structures to address the risk of "bailouts" of failing funds, they should use those more targeted measures. And if members of Congress – including Chairman Dodd, one of Dodd-Frank's two principal authors – have consistently and repeatedly said they do not believe venture capital should be restricted by the Volcker Rule, we believe the Agencies should give due weight to those statements of intent.

Finally, we believe the Agencies should conduct a proper cost-benefit analysis of any fund structure they consider including in the definition, and impose Volcker's framework (rather than safety and soundness regulation) on funds only where the benefits of this incremental regulation outweigh its costs.[81]

Under such an approach, we believe the Agencies should conclude that venture investments lie outside the proper definition of covered funds. Venture capital funds are fundamentally different from hedge funds and private equity funds – in terms of their risk profile, their social and economic benefit, and their suitability to safety and soundness regulation. Regulating venture investments under Volcker either does not serve, or affirmatively undermines, the Rule's goals. Distinguishing venture gives appropriate weight to the

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companies and "levering them up"); *"Private Equity Performance"* at pages 1, 4, 7, 16, 21, 23, 24 (analyzing performance across the private equity asset class, but distinguishing venture and PE/buyout as two distinct types of funds within the asset class based, among other things, on the types of opportunities they pursue and the extent to which the funds use leverage to generate returns); *see also On the Lifecycle Dynamics of Venture-Capital- and Non-Venture-Capital-Financed Firms"* at page 3, 14 (venture "disproportionately" funds companies that have not yet reached the stage of earning revenues).

79 *"The Economics of Private Equity Funds"* at page 2. At that time, according to the authors, buyout funds managed about two-thirds of total venture-plus-buyout funds' capital, and buyout funds' use of leverage can multiply their investment size by three or four times base capital.

80 *"The Economics of Private Equity Funds"* at pages 4-5, 13-14, 21-23. According to the authors, "[i]t is not clear exactly what the[] transaction fees [charged by buyout funds] are paying for." *Id.* at pages 21, 22.

81 *See* Section V infra.

conclusions reached by the Financial Stability Oversight Council, and can be done on a clear and predictable basis by relying on the definition of venture funds the SEC adopted pursuant to Dodd-Frank Title IV. It is consistent with clear statements of Congressional intent, [82] and the only reasonable outcome of a rigorous cost-benefit analysis.

2. *If the Agencies Decline to Refine the Definition of Covered Funds, They Should Permit Banking Entities to Sponsor and Invest in Venture Capital Funds Under Section (d)(1)(J)*

If the Agencies decline to refine the definition of hedge funds and private equity funds, they should permit banking entities to continue to sponsor and invest in venture funds pursuant to Section 13(d)(1)(J) of the Bank Holding Company Act. Under this provision, the Agencies may permit banking entities to engage in an activity otherwise prohibited by the Volcker Rule if they determine, by rule, that the activity "would promote the safety and soundness of the banking entity and the financial stability of the United States."

a. Properly Conducted Venture Investing Promotes Safety and Soundness

Properly conducted venture capital investing can promote safety and soundness. Silicon Valley Bank is a case in point. SVB focuses exclusively on serving companies in the technology, life sciences, and clean technology sectors. Its ability to lend effectively depends on its deep understanding of the sectors it serves, its individual client companies, and the external trends that affect its clients and markets. Its business model gives it opportunities to work directly with the sources of capital for high growth companies (the limited partners who invest in venture capital funds), the investors in high growth companies (the general partners in venture capital funds) and the companies themselves. These interactions help broaden and deepen SVB's insights into market sectors and emerging trends, as well as its relationships with key decision-makers. This, in turn, helps SVB lend wisely and effectively, based on its ability to

[82] *See*, *e.g.*, Colloquy between Senators Dodd and Boxer,, 156 Cong. Rec. S5904 – S5905 (July 15, 2010) ("properly conducted venture capital investment will not cause the harms at which the Volcker Rule is directed"); Statement of Representative Eshoo, 156 Cong. Rec. E1295 (July 13, 2010) ("I expect the regulators to … clarify that … venture capital funds … fall outside the definition of "private equity funds"); *see also* Letter from Paul A. Volcker to the Hon. Timothy Geithner (Oct. 29, 2010) (any ambiguities within the language of the law "need to be resolved in light of carrying out the basic intent of the law"); Colloquy between Representatives Representative Frank and Himes, 156 Cong. Rec. H5226 (June 30, 2010) (confirming 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 and expressing confidence that the Agencies would draw and maintain appropriate distinctions); *see generally* 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); Letter from Senator M. Warner to the Financial Stability Oversight Council (Jan. 5, 2011); Letter from Representative G. Moore to Secretary T. Geithner (January 17, 2011); Letter from Representative A. Eshoo to the Agencies (Dec. 13, 2011); Letter from Senator K. Hagan to the Agencies (Jan. 13, 2012); Letter from Representative M. Honda to the Agencies (Dec. 20, 2011); Letter from Representative Z. Lofgren to the Agencies (Dec. 23, 2011); Letter from Representative D. Matsui to the Agencies (Feb. 9, 2012)Letter from Representative D. Schweikert to the Agencies (Dec. 16, 2011); Letter from Representative J. Speier to the Agencies (Jan. 23, 2012).

distinguish real risk from perceived risk and to maintain a proactive, forward-looking view of the sectors it serves.[83]

SVB's high market share, strong loan growth, solid credit quality, and consistent financial performance illustrate how its model creates positive outcomes for it and for its clients.[84] While we cannot quantify the precise extent to which our venture capital investments help promote our strong performance, we believe that our focus, the breadth and depth of the ways in which we interact with our target markets, and our overall business model – serving clients throughout the cycle of capital formation, investment, growth, and liquidity – help to create and reinforce our strength and effectiveness.[85]

More generally, we believe there are a relatively small handful of other banks who also use venture investing to enhance their ability to serve their clients and promote their overall safety and soundness. This includes a small number of institutions that serve venture-backed companies, as well as a handful of banks with expertise in particular sectors or specific geographies that are aligned with a venture fund's investment focus on that sector or region.[86]

We cannot comment in similar depth about the impact venture capital investing has on other banks' safety and soundness. A 2007 study that examined bank investments in venture capital over a twenty year period, however, found that venture investing has been good for banks' effectiveness in lending *and* for banks' clients.[87] According to the study, the data "supports the hypothesis that building relationships in the venture capital market complements the banks' lending business."[88] Specifically, the study found, "having established a relationship at the venture capital stage increases a bank's chance of making a loan to a particular company."[89] In addition, the study found the relationship was economically beneficial not only for the bank (in terms of better access to loan deals) but also for the client company, in terms of better loan pricing.[90]

b. Properly Conducted Venture Investing Promotes Financial Stability

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83 SVB maintains strict controls and processes to ensure that confidential information from its investing arm is not shared with the bank, and vice versa, and to ensure that its equity investments are not co-mingled with lending in a way that would jeopardize its rights as a secured lender.

84 *See* page 3.

85 The relationship between SVB's business model and its financial performance has been acknowledged by third parties. *See, e.g.,* Morningstar Equity Research, *"SVB Financial Group"*(Dec. 20, 2010) at page 2 (noting SVB's "deep tendrils" and their positive effect on credit quality), *available by subscription at* www.morningstar.com.

86 See, e.g., Letter from River Cities Capital Funds (Feb. 2, 2012); Letter from Physic Ventures (Feb. 7, 2012).

87 T. Hellmann, L. Lindsey, M. Puri, *"Building Relationships Early: Banks in Venture Capital,"* The Review of Financial Studies Vol. 21, Issue 2 (May 2007), at page 4, *available at* http://ssrn.com/abstract=474500. The study examined venture investments made between 1980 and 2000, prior to passage of the Gramm-Leach-Bliley Act, through either Small Business Investment Corporations or directly under Section 4(c)(6) of the Bank Holding Company Act of 1956. *Id.* at pages 6, 8-9.

88 *"Building Relationships Early"* at page 4.

89 *"Building Relationships Early"* at page 15, 16-22.

90 *"Building Relationships Early"* at page 24-25.

The Agencies have latitude in deciding how to define "financial stability" for purposes of applying Section (d)(1)(J) of the Volcker Rule. The statute does not define this term, and there is no generally agreed definition of the term or target variable used to measure its presence.[91] In fact, the Financial Stability Oversight Council affirmatively declined to adopt a definition in a recent rulemaking, choosing instead to continue using a principles-based approach to determinations that turn on "financial stability."[92]

In a recent paper delivered at the Stanford University Graduate School of Business, Eric Rosengren, President and Chief Executive Officer of the Federal Reserve Bank of Boston, proposed defining financial stability as the "ability of the financial system to consistently supply the credit intermediation and payment services that are needed in the real economy if it is to continue on its growth path."[93] Using this definition, venture investing promotes financial stability. It is well documented that venture investing creates new companies and new industries characterized by strong, sustained earnings growth – thereby increasing both the aggregate demand for the financial system's core credit intermediation and payment services, as well as the aggregate financial strength of the companies to whom the financial system provides these services. In addition, individual institutions that engage in venture investing gain broader, deeper perspectives of the market and other forces affecting their clients. These, in turn, allow them to make better informed credit decisions, increasing the system's ability to supply credit intermediation and payment services to high-growth companies on a consistent, predictable, and stable basis.[94]

Garry Shinasi offered a somewhat broader definition of financial stability in an IMF Working Paper on the topic. According to Mr. Shinasi:

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91 *See, e.g.,* Eric S. Rosengren, President & Chief Executive Officer, Federal Reserve Bank of Boston, "*Defining Financial Stability, and Some Policy Implications of Applying the Definition*" (June 3, 2011) at page 1, *available at* www.bos.frb.org/news/speeches/rosengren/2011/060311/index.htm; Garry J. Schinasi, "*Defining Financial Stability*", IMF Working Paper WP/04/187 (October, 2004) at page 3, *available at* cdi.mecon.gov.ar/biblio/docelec/fmi/wp/wp04187.pdf .

92 *See* Financial Stability Oversight Council, "*Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies,*" 76 Fed. Reg. 17 at 4561 (Jan. 26, 2011) (electing to rely on a framework that uses qualitative metrics rather than an explicit definition of the term "financial stability" to determine when non-bank financial companies pose a threat to financial stability and require increased prudential regulation).

93 Rosengren: "*Defining Financial Stability*" at page 2. Conversely, Mr. Rosengren defines financial instability as occurring "when problems (or concerns about potential problems) within institutions, markets, payments system, or the financial system in general significantly impair the supply of credit intermediation services – so as to substantially impact the expected path of real economic activity." *Id.*

94 To use the words of Mr. Rosengren, the knowledge gained through venture investments can help a bank develop "expertise in identifying creditworthy investment opportunities, monitoring the investments, and obtaining the benefits of diversification" and, therefore, enhance its ability to effectively "tak[e] funds provided by depositors or investors, and lend[] those funds to individuals and firms that run businesses and employ people in the real economy, and thus have opportunities for higher potential returns." Rosengren: "*Defining Financial Stability*" at page 3; *see also* "*Building Relationships Early*" at page 25 (bank venture investing provides banks' access to better loan deals and lower spreads to borrowers). Activities that promote the financial system's ability to provide credit to small, high growth companies is particularly important, given how few financial firms are willing to lend to start-up companies and these companies' critical role in economic growth and job creation.

"Broadly, financial stability can be thought of in terms of the financial system's ability: (a) to facilitate both an efficient allocation of economic resources – both spatially and especially intertemporally – and the effectiveness of other economic processes (such as wealth accumulation, economic growth, and ultimately social prosperity); (b) to assess, price, allocate, and manage financial risks; and (c) to maintain its ability to perform these key functions – even when affected by external shocks or by a build up of imbalances – primarily through self-corrective mechanisms.

A definition consistent with this broad view is as follows:

'A financial system is in a range of stability whenever it is capable of facilitating (rather than impeding) the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events."[95]

Venture capital even more clearly promotes financial stability under this broader view. As discussed above, venture capital investments contribute broadly and deeply to the efficient allocation of economic resources and the effectiveness of economic processes, driving meaningful wealth accumulation for the economy at large (and for some individual investors and entrepreneurs), increasing economic growth, and promoting social prosperity. Bank sponsored venture capital funds provide third-party investors with access, through a trusted intermediary, to high performing companies and top tier venture funds, thus facilitating the efficient allocation of resources, the rate of growth of output, and the processes of saving, investment, and wealth creation.[96] In fact, SVB's model – which includes working with its clients throughout the entire cycle of investing capital, growing companies, and creating liquidity (which can then be reinvested, re-starting the cycle) – is well aligned with Mr. Shinasi's description of financial stability as occurring across a set of variables that quantify "how well finance is facilitating economic and financial processes such as savings and investment, lending and borrowing, liquidity creation and distribution, asset pricing, and ultimately wealth accumulation and growth."[97]

Mr. Rosengren and Mr. Shinasi, as well as other commenters, have also recognized that financial stability can be understood at an even broader, more fundamental level. Under this view, financial stability is a counterpart to economic stability, economic growth, economic performance, job creation, and strong employment levels.[98] For the reasons discussed above, venture capital unquestionably promotes financial stability when viewed through this lens.

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95 Shinasi: *"Defining Financial Stability"* at page 8.

96 Shinasi: *"Defining Financial Stability"* at page 9; *see also "Does Venture Capital Investment Spur Investment Growth?"* at page 4 (discussing the important role venture capital plays in selecting innovative ventures and creating a smooth matching process between firms and financiers); *"A New European Regime for Venture Capital,"*(Oct. 2011) at page 2 (venture capital has a lasting effect on the economy as it mobilizes stable investment).

97 Shinasi: *"Defining Financial Stability"* at page 8.

98 *See also* Shinasi: *"Defining Financial Stability"* at page 7 (arguing that financial stability should be considered in light of the potential consequences for the real economy) and page 10 ("A stable financial system is one that enhances economic performance in many dimensions, whereas an unstable financial system is one that detracts from economic performance."); Rosengren: *"Defining Financial Stability"* at pages 2, 3 (the core objective of financial stability is to allow the real economy to continue on its growth path, and one of the three key elements

As a number of commentators have acknowledged, policies can promote financial stability either by *encouraging* activities that increase financial *stability*, or by *discouraging* activities that increase financial *instability*. In either case, the policies in question promote financial stability by altering the overall mix of activity in a way that increases the relative share of "desired" activity and reduces the relative share of "risky" activity. Venture capital investing also promotes financial stability using this measure, in that it tends to negate, or at a minimum avoid increasing, financial *instability*.

According to the Financial Stability Oversight Council, three "classic symptoms of financial instability" are "a broad seizing up of financial markets, stress at other financial firms, and a deep global recession with a considerable drop in employment."[99] Venture investing does not contribute to the first two of these indicators of financial stability. These investments are disconnected from public markets and, because they do not rely on leverage or employ complicated financial instruments, they do not affect financial markets negatively or create stress across financial firms. Even the 2002 "dot-com bust" did not cause financial markets to seize up and was not an example of financial instability, according to Mr. Rosengren.[100] Venture's role in job creation does, however, help alleviate the third "classic symptom" of financial instability, employment declines.

In fact, venture investing has a fundamentally counter-cyclical nature that can help dissipate financial imbalances and mitigate periods of financial (and economic) instability.[101] In many notable cases, entrepreneurs and venture investors have moved aggressively during financial downturns to create successful companies, capitalizing on the availability of talented employees, the lack of compelling opportunities in traditional companies, decreased valuations, and the opportunities for disruptive innovation that arise during periods of economic dislocation.[102] According to a 2008 article in Business Week, 18 of the 30 companies then on the Dow Jones Industrial Index – and major companies including Johnson & Johnson, Caterpillar, McDonalds, Walt Disney, Adobe, Intel, Compaq, Microsoft, Schwab, and Sun Microsystems – all were formed during economic downturns.[103]

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in its definition is the impact on the real economy); Shinasi: *"Defining Financial Stability"* at page 13, citing John Chant and others from the Bank of Canada ("Financial instability refers to conditions in financial markets that harm, or threaten to harm, an economy's performance through their impact on the working of the financial system."); Michael Foot, Managing Director, U.K. Financial Services Authority, *What is Financial Stability and How Do We Get It?,* at paragraph 16 (April 3, 2003), *available at http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2003/sp122.shtml* ("…we have financial stability where there is: (a) monetary stability (as defined above); (b) employment levels close to the economy's natural rate; (c) confidence in the operation of the generality of key financial institutions and markets in the economy; and (d) where there are no relative price movements of either real or financial assets within the economy that will undermine (a) or (b).")

99 *"Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies"* at 4556.

100 Rosengren: *"Defining Financial Stability"* at pages 6-7.

101 *Cf. "Promoting Longer-Term Investment by Institutional Investors"* at pages 1-2 (long term institutional investors – of the type that invest in venture funds – act as shock absorbers at times of financial distress and act in a counter-cyclical manner, thereby promoting financial stability, helping to correct speculative excesses, providing a buffer during a financial crisis and helping to avoid the short-termism that is increasingly prevalent in financial markets).

102 *See* V. Wadhwa, "*Startups: The Upside of a Downturn,*" Bloomberg Businessweek (Nov. 7, 2008).

103 *Id.*

Venture investing also lacks a host of other characteristics that are commonly linked to financial instability and systemic risk, including most importantly size, interconnectedness, and the presence of common, widely-held exposures.[104]

Finally, there is clear evidence that key members of Congress expect the Agencies to use the authority given to them in subsection (d)(1)(J) as needed to ensure that properly conducted venture investing may continue. Both at the time of Dodd-Frank's passage and more recently, Members from both the House and the Senate and from both sides of the aisle have reiterated on the record that the Agencies have ample discretion under subsection (d)(1)(J) and should use that discretion to exempt venture capital investments from the Volcker Rule.[105]

3. *The Agencies Can Look to the Investment Advisers Act to Define a Venture Capital Fund*

Venture capital funds can be clearly defined based on characteristics that differentiate them from hedge funds and private equity funds. These characteristics include minimal use of leverage, minimal public market investing, and long-term investors who cannot withdraw or redeem their investments absent extraordinary circumstances. These are important distinctions because they all contribute to why venture funds do not pose any systemic risk.

As discussed above, leverage creates a multiplier effect and counterparty risk – in colloquial terms, a dollar lost is not always a dollar lost. Investing in public markets creates more potential risk than investing in privately traded companies because public markets move quickly (and prices are therefore more volatile), and because public equity price swings can be caused by – or contribute to – broader market swings. Finally, allowing investors to withdraw or redeem their investments on a short-term basis can lead to a "run on the fund" during times of

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104 *See, e.g., "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies"* at 4560-61 (citing criteria that indicate the potential for spillovers from an individual firm's distress to the broader financial system or real economy and, therefore, indicate a greater systemic threat to financial stability).; Rosengren: *"Defining Financial Stability"* at pages 10-11 ("another vulnerability [that can lead to financial instability] is the risk that common, widely-held exposures could cause intermediation services to be cut simultaneously, even without a failure of any large intermediary"); *id.* at 12-13 (discussing financial instability caused by the failure of a large, interconnected intermediary, whether due to immediate credit exposures, "opaqueness" that makes it difficult to determine whether counterparty or other exposures exist, or the failure of significant market makers or global financial intermediaries); Shinasi: *"Defining Financial Stability"* at page 7 (in the absence of contagion and the high likelihood of systemic effects, disturbances in financial markets may be viewed as welcome – if not healthy – from a financial stability perspective).

105 Statement of Senators Dodd and Boxer, 156 Cong. Rec. S5904 – S5905 (July 15, 2010) (emphasis added) ("[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(d)(1)(J)."; Statement of Senator Brown, 156 Cong. Rec. S6242 (July 26, 2010) ("Regulators should carefully consider whether banks that focus overwhelmingly on lending to and investing in start-up 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."); Letter from Senator M. Warner to the Financial Stability Oversight Council (Jan. 5, 2011); *see generally* letters cited in note 82.

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extreme market turbulence. When a fund faces high investor redemptions at the same time, it may no longer have the funds to stay in business.

Rule 203(l)-1 of the Investment Advisers Act addresses all of these characteristics that make venture capital funds less risky than hedge or private equity funds – leverage redemption rights and public market investing. The rule focuses on funds that do not use significant leverage, do not offer investors routine redemption rights, and invest at least 80 percent of their committed capital in qualifying portfolio companies. Qualifying portfolio companies must not be publicly-traded at the time the fund makes its investment.[106]

If the Agencies decide to adopt a definition of venture capital in order to distinguish it from private equity, we believe that Rule 203(l)-1 of the Advisers Act provides a workable foundation, with a few refinements.

First, the Agencies should clarify that venture lending funds are not covered by the Volcker Rule.[107] The SEC defined venture capital funds in order to exempt them from registration, as directed by Congress. In doing so, they focused exclusively on funds that invest in start-ups using equity. However, there are a small number of venture funds that provide capital to start-ups in the form of loans. Permitting banking entities to also sponsor and invest in these "venture lending" funds is consistent with the goal of providing a full array of capital to fund high growth companies, and will help make credit more readily available, particularly to our nation's small businesses.

A venture lending fund is a type of "credit fund" that provides loans to start-up companies. In essence, investing in a credit fund is a form of lending, which is part of a bank's core business and should not be restricted. Using a fund structure allows third party investors to provide more capital to lend and effectively allowing a bank to syndicate and diversify its risk.

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[106] For the purpose of the Advisers Act, a venture capital fund is defined as a "private fund" that meets b) to f) below: b) represents itself as pursuing a venture capital strategy to its investors and prospective investors; c) holds no more than 20 percent of its aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not qualifying investments; d) does not borrow, provide guarantees or otherwise incur leverage, other than limited short-term borrowing; e) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; and f) is not registered under the Investment Company Act and has not elected to be treated as a business development company. A "qualifying portfolio company" is any company that meets the following qualifications: (i) at the time of any investment by the fund, the company is not itself "reporting or foreign traded" (i.e. it is not subject to the reporting requirements of the U.S. Securities Exchange Act of 1934 and does not have securities listed or traded in a foreign jurisdiction), and does not control, is not controlled by and is not under common control with a "reporting or foreign traded" company; this generally means that investments in public companies are subject to the 20% non-qualifying "basket"; (ii) the company does not borrow or issue debt obligations in connection with the fund's investment in the company and distribute to the fund the proceeds of such borrowing or issuance in exchange for the fund's investment; and (iii) the company is not itself a "private fund". See *Investment Advisers Act, Rule 203(l)-1*; Letter from National Venture Capital Association (Feb. 3, 2012) at page 5 and Annex B.

[107] In response to Question 312, the agencies could exempt all lending (or "credit") funds from the Volcker Rule by expanding the exemption for loan securitization funds. Specifically, the Agencies should revise section 14(a)(2)(v) to delete the phrase "that is an issuer of asset-backed securities described in section 13(d)" from section 14(a)(2)(v), delete the phrase "supporting the asset-backed securities" from section 14(a)(2)(v)(B) and change the "and" following that subsection to an "or."

Additionally, loans are typically less risky than equity investing (creditors have superior legal rights to repayment than equity holders). It simply makes sense to include venture lending funds in any venture capital definition for purposes of an exemption from the restrictions of the Volcker Rule, unless the Agencies clarify that all lending or "credit" funds are separately exempted.

Second, the Agencies should clarify that any banking entity that invests solely in venture funds or other permitted investments is either included in the definition of a venture capital fund or excluded from the definition of a banking entity. Otherwise, venture capital funds-of-funds and joint ventures could be inadvertently restricted under the Volcker Rule. As long the investment ultimately goes to venture capital funds (and only to venture capital funds) it should not be restricted under the Volcker Rule. This exclusion is necessary for the same reasons that the Agencies excluded "covered funds" from the banking entity definition – to allow banks to sponsor and invest in funds-of-funds.

Funds-of-funds are vehicles that allow an investor to pool his or her investments in other investment funds. Because a venture capital fund-of-funds is diversified across a number of different venture capital funds, investing in a fund-of-funds is arguably safer than investing in a single venture capital fund. In addition, allowing banks to sponsor funds-of-funds helps them promote financial stability by aggregating capital and directing it to the highest performing venture investors.[108] Finally, banks can provide value to institutional investors who wish to invest in venture but lack access to the top funds, or who wish to rely on the banking entity's due diligence and general expertise on markets and on the best performing funds.

Finally, in order to make the rule workable given the long-term nature of venture investments, the Agencies should define a venture fund according to its status as of the time the banking entity makes its legal commitment to invest in the fund. Additionally, the rule should provide a safe harbor or presumption that a fund is a venture capital fund if it (a) holds itself out to investors as a venture fund and (b) is managed by an adviser who is exempt from registration under the Investment Advisers Act. For venture capital funds that are managed by an adviser that is registered (perhaps because they also advise hedge funds or private equity funds) the banking entity should be allowed to show that the subject fund met the definition of a venture capital fund at the time the commitment was made and that the bank has a good faith belief that the fund continues to meet the definition.

To accomplish the foregoing, the Agencies can exclude venture capital funds from Section 10(b)(1)(i)[109] by adding "except Venture Capital Funds" at the end of the section and define a venture capital fund as follows:

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[108] A number of studies have demonstrated "persistence" in venture fund performance – i.e., the ability for top performing general partners to consistently out-perform other general partners. This causes limited partners to highly value intermediaries who can provide access to top funds. *See generally "It Ain't Broke"* at pages 7-8.

[109] If the Agencies decline to exclude venture funds from the definition of covered funds but permit them under (d)(1)(J) , then the Agencies could add a new section 14(a)(2)(vi) as follows: A covered fund that is a venture capital fund as defined in Rule 203(l)-1 of the Investment Advisers Act, a Venture Lending Fund or any banking entity that invests solely in such funds or other permitted investments. A covered fund is presumed to be a venture capital fund if, at the time the banking entity makes a binding commitment to invest, the fund holds itself out as a venture capital fund and is managed by an adviser who is exempt from registration under the

A Venture Capital Fund is a fund as defined in Rule 203(l)-1 of the Investment Advisers Act, any fund that would be a Venture Capital Fund but for the fact that it provides loans to qualified portfolio companies (as defined in Rule 203(l)-1) and any banking entity that invests solely in Venture Capital Funds or other permitted investments. A fund is presumed to be a Venture Capital Fund if, at the time the banking entity makes a binding commitment to invest, the fund holds itself out as a Venture Capital Fund and is managed by an adviser who is exempt from registration under the Investment Advisers Act.

II. THE AGENCIES SHOULD MAKE SEVERAL OTHER CHANGES TO THE PROPOSED RULES

Even if the Agencies decide not to include venture capital funds under Volcker – but particularly if they do not take this step – there a several other changes we believe they should make to their proposed rules.

A. *Employee Retirement Plans, Including Employee Securities Companies, Should Not Be Prohibited from Investing in Covered Funds (Questions 5-7, 215-216, 233, 263)*

Employee retirement plans, such as a 401k, deferred compensation plan or Employee Securities Company, provide individuals with valuable ways to invest for retirement and diversify their investment portfolios. They also provide employers with valuable tools for employee recruitment and retention.

The Agencies should clarify that bank-sponsored employee benefit plans are not banking entities and may invest in covered funds because when a bank invests on the plan's behalf, it is not acting "as principal" under section 10(a).

One specific type of employee benefit plan is an Employee Securities Company. An ESC is a private investment fund formed for a company's employees that is registered with the Securities and Exchange Commission. Its purpose is similar to a company pension fund, 401k or other employee investment plan. An ESC is not a hedge fund or private equity fund and is partially exempt from the Investment Company Act under section 6(b), not 3(c)(1) or 3(c)(7); therefore, a banking entity is not prohibited from sponsoring or investing in an ESC under the Volcker Rule.

However, because an ESC is managed by the company on behalf of its employees, a bank sponsored ESC may be considered a bank affiliate and therefore a banking entity under the Agencies' proposed definition. As a banking entity, an ESC would be prohibited from investing in covered funds. The Agencies should revise the definition of banking entity to exclude ESCs and any other employee benefit plan, similar to the exclusion for customer funds, so that bank employees continue to have a means to invest in covered funds.

Investment Advisers Act. A Venture Lending Fund means a fund that, at the time the banking entity makes a binding commitment to invest, the fund would be a venture capital fund under Rule 203(l)-1 but for the fact that it provides loans to qualified portfolio companies. Additionally, the Agencies should not apply the restrictions in sections 16 and 17 of the proposed rule ("Super 23A") to venture funds or any other "permitted activities" under section 14, including investments in SBICs and other public welfare investments. Those activities do not pose systemic risk and should be governed by existing safety and soundness principles.

The Agencies can accomplish this by revising proposed rule 2(e)(4)(i) to add "or an employee benefit plan, including an Employee Securities Company" after "covered fund." Because the de minimus investment limits and other restrictions in section 11 and Subpart C would apply, there is no risk that a banking entity could use an ESC or other employee benefit plan to circumvent the Volcker Rule.

B. *Banking Entities Should be Permitted to Value Investments in Customer Funds at Cost (Questions 244, 256-257, 260-261, 265-266)*

Proposed section 12(c) appears to require banking entities to value their investments in customer funds (for purposes of calculating the 3% limits) in the same manner it uses to report values to investors. In most cases, this means the banking entity would need to follow GAAP and "mark to market" each investment using fair value accounting. This would punish banks for making good investments (because they go up in value) and reward them for making bad investments (because they go down, providing more room for new investments).

Forcing banks to use GAAP and mark to market their customer fund investments could cause a banking entity to exceed the aggregate 3% limit simply because the investments rise in value. This would subject them to penalties, prevent them from seeding new funds for advisory customers and force them to sell their best investments early, potentially breaching their agreements with, and fiduciary duties to, their customers. This risk is particularly acute for long term funds that do not allow investors to redeem investments during the fund's life, and for smaller institutions, who have a smaller total 3% "basket" for fund investments.

To avoid this perverse outcome, the Agencies should allow banking entities to value their investments in customer funds at cost.[110] Because cost-basis is stable, it would allow banking entities to more accurately monitor and forecast their 3% limits and would not punish banks for making good investments.

The rule could also require banks to use the same accounting method for the 3% limit consistently over the life of the investment, similar to the requirements of rule 203(l)-1(a)(2) of the Investment Advisers Act. Under this rule, advisors relying on the venture capital exemption are required to track the amount of non-conforming investments in each fund's "20% basket." Any investments in the basket are to be valued at either cost or fair value, but the method must be applied consistently.

The Agencies can permit the use of cost accounting for determining the value of customer investments for the aggregate 3% limit by adding the following to the end of section 12(c): "or valued at cost, consistently applied."

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[110] This is essentially the same as valuing the investment at the time it is made. See Question 266. For similar reasons, the Agencies should also permit a banking entity to bring its covered fund investments into compliance within a reasonable period of time if the entity's tier 1 capital decreases, using the existing extended conformance period. See Questions 268, 271.

C. ***The Agencies Should Not Expand the Volcker Rule to Cover "Parallel" Investments (Question 262)***

Section 12(b)(2)(B) of the proposed rule unnecessarily expands the Volcker Rule to merchant banking investments. It would either prevent many small and mid-sized banks from making legitimate investments in operating companies if those companies are within the investment strategy of one of their sponsored funds, or severely hamper small and mid-sized banks from sponsoring new funds for their customers.

Congress allowed banking entities to invest in their own sponsored funds, up to 3% per fund and 3% of the bank's tier 1 capital across all such funds, because it recognized that investors want to see the fund manager have "skin in the game" to create better alignment of interest. Unlike large money-center banks, 3% of tier 1 capital for small and mid-sized banks leaves very little (if any) room for commitments to new sponsored funds, particularly for banks who are already in the advisory funds business. Including merchant banking investments in the 3% limit could severely reduce the allowance and/or effectively prohibit legitimate merchant banking investments.

Additionally, any existing merchant banking investment could preclude a sponsored fund from investing in the same company. One can only imagine a bank holding company with a merchant banking investment in the next Apple or Google that had to either sell the investment prematurely or prevent its sponsored funds from investing in the same company.

Congress did not cover merchant banking investments in operating companies in the Volcker Rule and there is no evidence that such investments pose systemic risk to our financial system. [111] Quite the contrary, there is ample evidence that these investments in high growth small businesses strengthen our financial system by creating jobs and fostering innovation.

Expanding the Volcker Rule and reducing the 3% limits for investments in operating companies is unnecessary, unwarranted and harmful to our financial system. The Agencies should delete section 12(b)(2)(B).

D. ***The Agencies Should Clarify that the Deductions from Tier 1 Capital in Section 12(g) Apply Only to the Calculations Required by Section 12(c) under the Volcker Rule (Question 269)***

The Agencies should clarify that proposed rule 12(d) is not intended to change overall capital requirements, and applies only to the aggregate 3% limit on investments in permitted sponsored funds under proposed rule 12(c). Applying the deduction more broadly would increase overall reserve requirements, which would reduce available credit and harm the overall economy. Certainly this is not what Congress intended.

Section 13(d)(3) of the Volcker Rule provides that the Agencies shall impose additional capital requirements regarding the activities permitted under section 13(d) *if the Agencies determine that it is appropriate to protect the safety and soundness of banking entities engaged in such activities.* Neither the FSOC nor the Agencies have made such a showing.

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[111] Co-investments or parallel investments with hedge funds that constitute short-term trading are already covered by the Volcker Rule's proprietary trading restrictions.

Specifically, proposed rule 12(d) provides that a banking entity shall deduct permitted investments in covered funds from its tier 1 capital "for purposes of calculating capital pursuant to the applicable capital rules…" The Agencies should clarify that this deduction applies only for purposes of determining whether a banking entity is within the aggregate 3% limit provided in proposed rule 12(c), and does not apply to a banking entity's overall capital or reserve requirements.

This can be accomplished by adding the phrase "of this section" after "applicable capital rules" in section 12(d) of the rule.

Additionally, the rule should clarify that the deductions from tier 1 capital start at the end of the conformance period, including any extensions, to allow banking entities adequate time to prepare, and to conform the tier 1 capital calculations with the time period banks have to divest any non-conforming investments under the Volcker Rule.

E. ***The Agencies Should Allow Sponsored Funds Formed Prior to May 1, 2010 to Qualify as Advisory Funds Without Forcing Them to Breach Pre-Existing Obligations to their Investors (Questions 244, 248, 253-255, 263)***

Sections 11 and 12 of the proposed rules permit banking entities to sponsor and invest in sponsored covered funds if they comply with certain restrictions. Two of these restrictions are particularly problematic for pre-existing sponsored funds.

Section 11(g) prohibits a sponsored fund from having an investment from a director or employee who is not directly providing services to the fund. If a pre-existing customer fund already has investments from such directors and employees, it may be unable to force those individuals out of the fund.

Section 12 limits the amount of investment that a sponsored fund can have from the banking entity (the "3% limits"). If a sponsored fund has a pre-existing commitment from the banking entity to invest more than the 3% limits, forcing the fund to reduce the amount of the banking entity's commitment harms the other investors in the fund.

Investments in illiquid funds are long-term commitments, which the fund manager calls over time as the fund invests in underlying funds or companies. All of the investors in the fund depend on each other to fulfill their commitments, so that the fund has adequate capital to make the type of investments it promised to make when the fund was raised. If an investor breaches or defaults on its commitment can face harsh legal remedies, including forfeiture of their entire investment.

Additionally, investors want the fund manager (the general partner) to have a substantial commitment to the fund – and this amount is usually heavily negotiated - because the other investors want the manager to have enough "skin in the game" to create a proper alignment of interest with the other investors.

Forcing pre-existing sponsored funds to comply with the 3% limits and the prohibition on investments from certain employees or directors would force banks to breach contractual and fiduciary obligations to customers and employees, and potentially subject them to litigation. To avoid this harsh result, the Agencies should clarify that a customer fund that existed prior to the effective date of the Volcker Rule and does not accept new investors is "grandfathered" or exempted from any limitations in sections 11 or 12 that would require it to breach contracts with its customers or employees that existed as of May 1, 2010 in order to qualify as a permitted fund.

Additionally, Sections 11(f) and (h) are limitations that should logically apply only at the time a fund is organized and offered to investors. The Agencies should clarify that banking entities do not need to amend offering documents to change the names of pre-existing funds to comply with 11(f) or provide the disclosures required in 11(h). Changing the name of a fund often requires consent from the investors and any amendment to the fund's legal documents would force banking entities to incur significant attorney's fees and other costs for no good reason, particularly when the fund is not accepting new investors.

F. ***Banks Should Not Be Required to Ask Fund Managers for Permission to Sell Illiquid Assets to Qualify for the Illiquid Fund Extension (Questions 270-271)***

The Federal Reserve Board should revise its conformance period rules so that banks are not required to ask underlying managers for permission to sell or redeem their commitments before qualifying for the 5-year illiquid fund extension. Congress did not impose any such requirement. Congress made clear that the extended transition period was meant to satisfy pre-existing commitments – or, in the words of the statute, "to fulfill a contractual obligation that was in effect on May 1, 2010."

The plain meaning of the term "contractual obligation" is straightforward. According to Black's Law Dictionary, a "contractual obligation" is an "obligation which arises from a contract or agreement," and a "contract" is "an agreement between two or more persons which creates an obligation to do or not to do a particular thing. Its essentials are competent parties, subject matter, a legal consideration, mutuality of agreement, and mutuality of obligation."

Rather than relying on the plain meaning of "contractual obligation," the conformance rules state that a banking entity is considered to have a contractual obligation only if it has used "reasonable best efforts" to obtain consent to be relieved from the obligation and such consent has been denied. This leaves the fate of banking entities in the hands of private fund managers and secondary buyers. If a fund manager refuses to consent to a sale, the banking entity will be able (with the Federal Reserve's approval) to divest in an orderly manner, over an extended period. But if a fund manager consents, the banking entity will be forced to sell an illiquid asset, prematurely, at whatever price it is able to get.

Forced sales in illiquid markets do not yield fair prices. Buyers who know that a seller must sell have leverage to extract substantial price discounts. Sellers, facing a legal deadline, have no choice but to sell at whatever price buyers are willing to offer.[112]

Forcing sales of illiquid assets merely because a banking entity has the legal right to ask for consent to sell, and a fund general partner is willing to grant that consent, could thus result in a very significant transfer of wealth from banks to non-bank investors and in precisely the kind of disruption and losses Congress sought to avoid. It would be truly perverse if the Volcker Rule

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[112] SVB provided data on secondary market discounts in its comments on the Federal Reserve Board's proposed rules to implement the Volcker Rule's conformance period. *See* Letter from SVB Financial Group to the Board of Governors of the Federal Reserve System (Jan. 10, 2011) at page 6.

was implemented in a way that weakened banks and gave non-bank hedge funds, private equity funds and other buyers a free ticket to purchase bank assets at huge discount.

In addition, the Proposed Rules would open a Pandora's Box of other issues. Regulators will have to resolve potentially complicated questions of fact about whether a banking entity used "reasonable best efforts" to get consent, whether a banking entity was justified in refusing if the consent depended on the bank agreeing to onerous conditions, and the like. Outcomes would depend on the actions of individual fund general partners, and could vary dramatically across otherwise similarly situated assets or banking entities, for reasons totally unrelated to – or even directly contrary to – the statute's purpose. For example, it is entirely possible that general partners of strong, successful funds – which present no risk to the banking entity's safety or soundness – could use this as an opportunity to consent to transfers, at "fire sale" prices, solely to the fund itself or to favored investors, forcing losses on the bank and its investors and weakening the institution.

SVB urges the Board to revise the conformance rules to strike paragraph (iii) of its definition of "contractual obligation" and replace it with a definition that more closely tracks the plain meaning of the term and Congress' objectives, as follows:

> (iii) A banking entity shall be considered to have a contractual obligation for purposes of paragraph (b)(3)(i) or (ii) only if the banking entity, on or before May 1, 2010, entered into a written agreement, enforceable in accordance with its terms, pursuant to which the banking entity agreed to take or retain an equity, partnership, or other ownership interest in a fund.

G. *The Agencies Should Not Impose Restrictions on the Transferability of Carried Interest (see Question 234)*

The proposed rule's definition of carried interest is generally effective; however, it should not require that carried interest be non-transferable. There is no reason to impose this limitation. If a banking entity determines that selling or otherwise transferring a carried interest allocation is in the best interest of its shareholders, depositors and other customers, it should not be restricted from doing so. Forcing banks to waive the ability to transfer carried interest in order to avoid the risk that it be deemed an ownership interest serves no purpose and would hinder a bank's ability to sell such an interest if it determined such a sale was necessary or advisable.

H. *The Agencies Should Clarify That all CRA-Eligible Investments Are Permitted Under Section (d)(i)(E) (Question 280)*

In Section 13(a), the proposed rules expressly permit investments designed primarily to promote the public welfare and refers to a statute authorizing investments commonly referred to as Community Redevelopment Act (CRA) investments.

We believe the intent of this section is to permit all CRA investments. We request that the Agencies confirm that *all* CRA investments in covered funds that are eligible for CRA credit are permitted investments under the Volcker Rule. This would allow the Agencies to regulate these investments under existing safety and soundness principles.

III. THE AGENCIES SHOULD ADOPT A LESS EXPANSIVE APPROACH TO PROPRIETARY TRADING THAT ACHIEVES THE RULE'S PURPOSE WITHOUT IMPOSING UNREASONABLE BURDENS ON SMALL AND MID-SIZED BANKS

SVB does not engage in "proprietary trading" as that term is commonly understood or used. We run no proprietary trading desk; do not trade for our own account through short-term trades; and none of our employees are compensated or incentivized to make trades (risky or not) for the benefit of a company account.

However, the current proposal defines proprietary trading in very broad terms, and then puts the burden on each institution to prove it does not conduct prohibited trades. This "guilty until proven innocent" approach will impose substantial costs for all institutions, but those costs will be felt most heavily by smaller and mid-size institutions who have limited scale over which to spread the compliance costs.

The proposed tiering of the Rule's obligations based on volume recognizes the problem, but it does not provide a solution. The continuing obligation to identify any potential trades that fall within a very broad definition of "proprietary" and the obligation to demonstrate that trades or other business operations fit within one of the identified exceptions will be a cumbersome and costly process. For example, SVB provides foreign exchange services for clients, but does not make foreign currency trades for its own account. The proposed rules will greatly complicate both the operations and the compliance program necessary to continue to offer this product, which our clients need and expect. Moreover, the broad definition given to the term "proprietary trading" will create uncertainty that will unnecessarily chill perfectly appropriate commercial activity. The end result of this regulatory process will be to artificially increase competitive advantages for larger institutions. Healthy, growing mid-size institutions, like ours, will face disproportionate regulatory burdens as we challenge larger banks in the marketplace. This ironic result would be the complete opposite of a major goal of Congress in passing the Dodd-Frank Act.

IV. THE AGENCIES SHOULD PROVIDE ADDITIONAL TIME FOR BANKING ENTITIES TO COME INTO COMPLIANCE (QUESTIONS 1-4)

The proposed rule does not provide enough time for banking entities to properly meet the various requirements of the Volcker Rule. Among other things, it seems obvious that the Agencies must issue a final rule with clearly understandable compliance obligations in order to permit entities to develop and implement an effective compliance program. Because the proposal touches so many complex activities within an institution, many of which touch only peripherally the goals Congress identified for the Volcker Rule, institutions will require time to analyze how the rule affects each aspect of its operations.

The Dodd-Frank Act itself recognizes that institutions need time to come into compliance with the many changes imposed by the Volcker Rule. The Act explicitly provided a two year transition period from the effective date to the date mandated for compliance with the substantive provisions of the Rule and established separate extended conformance periods for certain activities. Yet the Agencies' proposal would force entities to have a compliance program in place on July 21, 2012. Not only is this inconsistent with the intent of the Dodd-Frank Act, it is simply impracticable, particularly given the delays experienced by the Agencies in finalizing rules.

As currently drafted, there is not sufficient time to prepare to comply with the prohibitions and restrictions on proprietary trading and covered funds activities and investments (Question #1), and the proposed effective date does not provide sufficient time to implement the proposals compliance program requirements (Question #2). It is similarly true that the proposal fails to provide sufficient time to implement properly its reporting and recordkeeping requirements (Question #3). Rushing to meet an artificial deadline to establish a compliance program that is not aligned with substantive implementation deadlines will lead to errors, confusion and a waste of time and money. Regulators should wait until a final rule is issued, offering clear definitions and guidance. Then the compliance obligations should be implemented gradually in a phased approach (Question #4). Initial compliance obligations should be aimed at gathering information so that the conformance period can be used to refine compliance programs and fit them better to meet the risks presented by different institutions. This approach would both address the concerns of the Volcker Rule and help reduce unnecessary regulatory burdens.

V. THE AGENCIES MUST CONDUCT A THOROUGH COST-BENEFIT ANALYSIS AND ADOPT RULES ONLY IF THEIR BENEFITS EXCEED THEIR COSTS

In Executive Order 13579, President Obama specifically directed independent regulatory agencies, such as the Agencies, to "promot[e] economic growth, innovation, competitiveness, and job creation,"[113] and affirmed that regulatory decisions should be made only after accounting for the costs and benefits of regulatory actions. Other Executive Orders (including EO 12866 and EO 13563) require detailed economic analyses considering the costs and benefits of a particular regulatory action and its alternatives. The D.C. Circuit has warned that a regulatory agency's "failure to apprise itself – and hence the public and the Congress – of the economic impact of a proposed regulation makes promulgation of the rule arbitrary and capricious and not in accordance with law."[114]

Each of the Agencies expressly affirmed that it would follow the President's directives and use cost-benefit principles when engaged in rulemaking. For example, the FDIC stated that it would proceed with rulemaking consistent with "the spirit of, and principles found in," the above-noted Executive Orders.[115] Similarly, the SEC affirmed that its "current rulemaking procedures are closely aligned with the requirements" of the Executive Orders and noted that its

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113 76 Fed. Reg. 41587 (Jul. 14, 2011).

114 *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011).

115 Office of the Inspector General, FDIC, *"Evaluation of the FDIC's Economic Analysis of Three Rulemakings to Implement Provisions of the Dodd-Frank Act,"* Report No. EVAL-11-003 (June 2011) at page 1 of the Executive Summary, *available at* www.fdicoig.gov/reports11/11-003EV.pdf. The OCC stated that its economic analysis processes "comply with the tenets of [Executive Order 12866]." Office of the Inspector General, Treasury Dep't, *"Dodd-Frank Act: Congressional Request for Information Regarding Economic Analysis by OCC,"* (June 13, 2011) at page 4, *available at* www.treasury.gov/about/organizational-structure/ig/Documents/OIG-CA-11-006.pdf. The Federal Reserve conducts rulemaking "consistent with the philosophy and principles" of the Executive Orders. Office of the Inspector General, Federal Reserve Board, *"Response to a Congressional Request Regarding the Economic Analysis Associated with Specified Rulemakings,"* (June 13, 2011) at page 9 (*avail. at* www.federalreserve.gov/oig/files/Congressional_Response_web.pdf).

economic analyses consider not only the entities within its jurisdiction (such as broker-dealers and investment companies) but also "industries not subject to SEC regulation."[116]

SVB respectfully submits that the Agencies have not conducted a thorough cost-benefit analysis, as required by the Executive Orders and as contemplated by the Agencies themselves. We believe the Agencies must take this step and ensure the results of this analysis shape their final rules.

On the merits, we believe that if the Agencies were to adopt the statutory definition of covered funds without modification – and, in particular, if they were to include venture capital funds within the scope of that definition – their action would not satisfy the requirement that they conduct a thorough cost-benefit analysis and, as a result, could not withstand judicial scrutiny. Subjecting venture investments to Volcker's rigid, "one size fits all" framework – designed to deal with high risk, short term trading through a fund structure – rather than continuing to regulate these investments under safety and soundness principles would impose real costs on banking entities, on the venture capital sector, on start-up companies, and on the economy as a whole, with no commensurate benefits.

CONCLUSION

SVB thanks the Agencies for the opportunity to comment. If you have any questions, please do not hesitate to call me at 650.320.1119.

Sincerely,

Mary Dent
General Counsel
SVB Financial Group

cc: The Honorable Timothy F. Geithner
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

[116] Office of the Inspector General, SEC, *"Report of Review of Economic Analyses Performed by the Securities and Exchange Commission in Connection with Dodd-Frank Rulemakings,"* (June 13, 2011) at page 4, *available at* www.sec-oig.gov/Reports/AuditsInspections/2011/Report_6_13_11.pdf.