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Submitted electronically

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

Ladies and Gentlemen:

I am writing on behalf of the Information Technology & Innovation Foundation ("ITIF") in response to the Notice of Proposed Rulemaking in the above proceeding.

ITIF urges the Agencies to carefully consider the ramifications of their actions as they adopt final rules in this proceeding. Specifically, ITIF believes that the Agencies should implement the Volcker Rule so that it affects the two types of funds referred to explicitly by Congress – private equity funds and hedge funds – and does not sweep in other activities that do not present the type of risk Congress sought to regulate. In particular, ITIF urges the Agencies not to apply the Volcker Rule to venture capital funds and investments.

ITIF is a non-profit, non-partisan research and educational institute—a think tank—whose mission is to formulate and to promote public policies to advance technological innovation and productivity internationally, in Washington, and in the states. Recognizing the vital role of technology in ensuring prosperity, ITIF focuses on innovation, productivity, and digital economy issues.

Technological innovation, particularly in information technology, is at the heart of America's economic prosperity, accounting for more than 50 percent of the country's economic growth since World War II. Crafting effective policies that boost innovation and encourage the widespread "digitization" of the economy is critical to ensuring robust economic growth and an improved standard of living. As a result, ITIF's mission is to help policy makers at the federal and state levels better understand the nature of the new innovation economy and the types of public policies needed to drive innovation, productivity, and broad-based prosperity for all Americans.

ITIF has researched and written extensively on the intersection between innovation policy, on the one hand, and economic growth and global competitiveness, on the other. We believe the decision you make in this proceeding will have a direct effect on the availability of capital to fund innovative companies, and hence on the strength of our economy and U.S. global competitiveness.

As a threshold matter, ITIF believes the Agencies have the discretion they need to regulate the problems Congress intended to address without sweeping in the venture capital industry. As the statute indicates and as the Financial Stability Oversight Council confirmed, the Agencies may refine the definition of covered funds to exclude venture capital funds, and may also treat venture capital investing as a "permitted activity" under Section (d)(1)(J).[1]

There are several reasons why the Agencies should take this step.

Innovation is a crucial underpinning to economic growth. Economists and policy makers have increasingly realized that it is not so much the accumulation of more savings or capital but rather innovation—improving and creating new products, processes, services, businesses and organizational models—that drives countries' long-term economic growth and improvements in standards of living.[2] While theorists blame a number of factors for the current anemic level of job growth in the United States, ITIF believes that the most accurate—and most commonly overlooked—cause is the failure of the United States to maintain its innovation-based competitive position in the world economy.[3]

Venture capital investments contribute meaningfully to innovation-based competitiveness. ITIF believes that a relatively small number of identifiable and quantifiable factors are at the heart of an economy's ability to create innovation-led growth. We view venture capital as one of these core factors.[4] Our view is echoed by a host of other commentators, who have documented the role venture capital and high growth start-up companies play in promoting innovation-led economic growth, driving the creation of new technologies and new economic sectors that promote global competitiveness, and spurring job creation.[5]

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[1] In its Report and Recommendations on the Volcker Rule, the Financial Stability Oversight Council (the "Council") found that whether the Volcker Rule should apply to venture capital funds was a "significant" issue. It recommended that the Agencies carefully evaluate whether the definition of covered funds is overbroad and consider narrowing it by rule. Financial Stability Oversight Council, *"Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds,"* January 2011 at page 62. In the related footnote the Council cited section (d)(1)(J), implying that the agencies may also allow banking entities to continue to sponsor and to invest in venture capital funds as "permitted activities" under this section of the Volcker Rule. *Id.* at note 54.

[2] S. Ezell, *"The Atlantic Century II: Benchmarking Asian, EU, and U.S. Innovation and Competitiveness,"* December 2011 (article), Bridges volume 32, December 2011, available at http://www.ostina.org/content/view/6148/1561/.

[3] R. Atkinson, "*Explaining Anemic U.S. Job Growth: The Role of Faltering U.S. Competitiveness*," December 2011, available at www.itif.org.

[4] R. Atkinson and S. Andes, "*The Atlantic Century II: Benchmarking Asian, EU, and U.S. Innovation and Competitiveness,"* July 2011 (report) at page 24, available at www.itif.org; *see also* R. Atkinson et al., *"Innovation Policy on a Budget: Driving Innovation in a Time of Fiscal Constraint,"* September 24, 2010 at page 2 (discussing broader impact innovative companies have on economic activity , including expanding exports, creating a "virtuous cycle" of expanding employment, and increasing productivity).

[5] *E.g.*, T. Meyer, *"Venture Capital Adds Economic Spice"*, Deutsche Bank Research, September 14, 2010 (demonstrating that changing levels of venture investing affect the level of economic growth); IHS Global Insight/National Venture Capital Association, *"Venture Impact: The Economic Importance of Venture Capital-Backed Companies to the U.S. Economy,"* 2011 (venture-backed companies generate 11 percent of private sector employment and 21 percent of U.S. GDP and create sustainable industries); J. Haltiwanger *et al*, *"Who Creates Jobs? Small vs. Large vs. Young,"* NBER Working Paper No. 16300, August 2010; L. Klapper *et al*, *"The Impact of the Financial Crisis on New Firm Registration,"* Policy Research Working Paper 5444, The World Bank Development Research Group, October 2010 (young companies are the principal force behind gross and net new job creation, and entrepreneurship is essential for the continued dynamism of a modern market economy);

"Houston, we have a problem." Those who are sanguine about the United States' leadership in innovation-based economic performance or who believe policymakers can impose regulatory barriers to venture investing without harming our economy should look closely at the data, and take care. Today, the United States ranks fourth—not first, as many assume—in innovation competitiveness.[6] More disturbingly, the United States ranks second to last in terms of progress over the last decade.[7] In terms of venture capital investing as a percent of GDP, the United States ranks eleventh.[8] In terms of progress over the past decade in venture investing as a percent of GDP, the United States ranks third from last, with a decline of 67.5 percent over the 1999-2008 period.[9] The effect of the United States' declining share of global venture investing is compounded by the growing "investment deficit," the shortfall of government investments in scientific research, education, productive infrastructure, and new technologies that are needed to maintain our current standard of living and provide a foundation for long-term economic prosperity.[10]

Policy matters. In the end, innovation is driven by individual entrepreneurs and funded by individual investors. But policies shape the environment within which innovation occurs, and they can have a dramatic effect on a country's innovation capacity and the resulting strength of its economy. Countries that implement effective, well-constructed policies to promote innovation, productivity, and competitiveness are able to increase their innovation capacity and competitiveness.[11] For example, Singapore and Korea have not historically been considered leading innovation economies, but each has put in place a robust set of policies to lead in the knowledge economy and they now rank first and fifth in our innovation competitiveness ranking—ahead of, or roughly on par with, the United States.[12]

If the Agencies restrict banking entities' ability to sponsor and to invest in venture capital funds, they will compound the problems we are already seeing: a declining level of venture investing and a less vibrant U.S. innovation economy. There is no reason to believe that other investors will take up any slack they create, since there is no reason to believe available investors are sitting on the sidelines or would change their investment decisions solely because banking entities were no longer venture investors.

A fascinating 2004 OECD report prepared by Eric Bartelsman foreshadows the potential implications of such a change. This report found that the rates of innovation in U.S. and EU enterprises were the same. The United States, however, spawned more "winners" because it did a much better job than Europe of more quickly allocating capital and labor to the most promising innovative concepts and start-up businesses. Europe fell behind not because it lacked ideas, but because it was constrained by regulatory environments that impeded capital and labor movements and approached issues from a precautionary stance that ended up inhibiting innovation.[13]

National Venture Capital Association, *"Patient Capital: How Venture Capital Investments Drives Revolutionary Medical Innovation,"* (2007) (documenting venture-backed businesses contributions to medicine).

6 *The Atlantic Century II* at page 1.

7 *The Atlantic Century II* at page 1.

8 *See* The *Atlantic Century II* at pages 1, 24 (benchmarking 40 countries and four regions based on 16 key indicators of innovation competitiveness, including venture capital investing).

9 *The Atlantic Century II* at page 24. Data compiled by the National Venture Capital Association indicate that venture fundraising is down meaningfully, and is not sufficient to replenish the amount of capital currently being invested in start-up companies. *See, e.g., "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. *See also* Deloitte and Touche, L.L.P, *"2010 Global Trends in Venture Capital: Outlook for the Future,"* July 28, 2010 (investors expect venture investing in the United States will continue to contract and see a direct correlation between current trends in venture investing and the United States' long term dominance in the technology sector).

10 R. Atkinson *et al*, "*Taking on the Three Deficits: An Investment Guide to American Renewal,*" November 2011.

11 S. Ezell, *"The Atlantic Century II".*

12 S. Ezell, *"The Atlantic Century II".*

13 *See* S. Ezell, *"The Atlantic Century II".*

In essence, the Agencies must decide in this proceeding whether to follow the EU's path—regulating behavior and restricting the flow of capital because it *might* entail risk—or whether to follow a path that distinguishes real risk from perceived risk and carefully designs regulations to address the former without reacting to the latter. Over-regulating to eliminate phantom risks will not make the financial system safer, but it will harm the economy.

For all of these reasons, we feel that the agencies should exercise the discretion given to them by Congress and implement the Volcker Rule in a way that focuses on the types of activities named in the statute: proprietary trading, hedge funds, and private equity funds. Venture funds do not present risks to our financial system—they are small in scale, move at a slow, measured pace, are not tied to public equity markets, and do not rely on leverage.

As noted at the outset of this letter, there are two ways to achieve this outcome. One is to clarify the definition of covered funds to exclude venture capital funds. The other is to find that venture investing is a "permitted activity" under section (d)(1)(J). If you elect to use the second path, we believe you can and should conclude that bank-sponsored venture investing promotes the United States' financial stability.

While there is no accepted definition of "financial stability," commentators have highlighted the link between financial stability and a system's ability to efficiently allocate economic resources, create effective economic processes (including economic growth), and facilitate the performance of an economy.[14] As discussed earlier in this letter and in the reports I have cited, there is a strong and well documented link between venture investing and these outcomes. And because banking entities provide a meaningful share of U.S. venture capital,[15] this link applies to bank-provided venture capital as well.

Venture's long-term orientation and investment time horizon also help avoid some of the pitfalls of the short-termism prevalent in public markets, including pitfalls that contributed to the financial system's collapse. Moreover, a robust venture capital industry can contribute to financial stability. We believe that it was the lack of real innovation and growth opportunities that contributed to the housing bubble and financial crisis in the last decade. Had venture funding been higher there would have been more growth and more demand for capital in real wealth-creating investments, rather than in the housing finance Ponzi scheme.

As a number of other countries have realized (and acted upon), venture capital investments mobilize stable investment and fund a variety of long-term capital investment projects.[16] As a result, they promote financial stability by creating a stronger foundation for sustainable long-term growth. They also act as "shock absorbers" during times of financial distress; investing in a counter-cyclical manner that helps balance

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[14] G. Schinasi, *"Defining Financial Stability,"* IMF Working Paper, WP/04/187, page 8 ("a financial system is in a range of stability whenever it is capable of facilitating (rather than impeding) the performance of an economy...); *see also* Eric S. Rosengren, Federal Reserve Bank of Boston, *"Defining Financial Stability, and Some Policy Implications of Applying the Definition,"* June 3, 2011, at page 2 (discussing financial stability as ultimately tied to "the expected path of real economic activity").

[15] *See, e.g.,* Statement of SVB Financial Group, Joint Hearing of the House Financial Services Committee Subcommittees on Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit, *"Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation,"* January 18, 2012, at page 3 (estimating based on data from Preqin that banks provide at least seven percent of U.S. venture capital).

[16] OECD Discussion Note, *"Promoting Longer-Term Investment by Institutional Investors: Selected Issues and Policies,"* EUROFI High Level Seminary 2011, February 17-18 2011, at pages 1-2, *available at* http://www.oecd.org/dataoecd/37/42/48281131.pdf.

other swings in financial markets and helping institutional investors diversify their investment portfolios and improve their risk-return tradeoff.[17]

Finally, venture investing generally—and venture investing by banking entities in particular—helps promote the effective functioning of credit markets by augmenting the available sources of capital and by increasing lenders' expertise.[18] As the European Commission has recognized, "venture capital is an essential source of finance, in particular for innovative start-up businesses that face difficulty in accessing traditional bank lending or finance through stock exchanges."[19]

The experiences of the past several years have understandably led Congress, the Administration, and others to take steps to prevent a recurrence of the devastating losses Americans across the economy, and across the country, experienced. We agree with that impulse and with the need for policymakers to take strong steps toward a better, more fundamentally strong and stable future. However, we believe that commentators and policymakers have over-emphasized some causes of the great recession—including an out of control financial system—and failed to acknowledge the important role played by other causes—most importantly, the collapse of our innovation-based economy. We urge you to carefully consider the real problems facing our economy and our financial system, and to craft your regulations to solve those problems.

In our view, the bottom line is quite simple. Venture as a sector is too small and too unconnected to create systemic risk. To our knowledge, it has never led to any safety and soundness risk at any U.S. financial institution. Yet venture investing—including by banking entities—directly contributes to economic growth, job creation, and economic and financial stability. Policies like the ones you are adopting should promote—not restrict—activities like venture investing that do no harm, but that produce tremendous good.

Thank you for considering these views.

Sincerely,

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[17] *See, e.g., "Promoting Longer-Term Investment by Institutional Investors"* at page 1; Staff Working Paper, *"A New European Regime for Venture Capital,"* D.G. Internal Market and Services, *available at* http://ec.europa.eu/internal_market/consultations/docs/2011/venture_capital/consultation_paper_en.pdf.

[18] *See* Rosengren, *"Defining Financial Stability"* (defining financial stability based on a system's ability to provide effective credit intermediation and payment services).

[19] *"A New European Regime for Venture Capital"* at page 3.