



February 8, 2012

Jennifer J. Johnson  
Secretary  
Bd. of Governors of the Federal Reserve System  
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Washington, DC 20551

Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
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Washington, DC 20549-1090

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

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

Via Internet: [www.regulations.gov](http://www.regulations.gov)

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

Dear Ladies and Gentlemen:

We are pleased to have the opportunity to submit comments in response to your Agencies' joint notice of proposed rulemaking on the "Volcker Rule," which was passed as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. We write on behalf of ourselves and our firm, Scale Venture Partners. Our comments focus on Question 310, which concerns the appropriate treatment of venture capital funds under the rule.

### **Background**

Our firm, Scale Venture Partners, is a venture capital firm that invests in technology and health care startups. Since our founding in 2000, we have invested in more than 78 companies. We have attached a list of our current portfolio companies, to give you a sense for the diversity of our portfolio and the important contributions our clients are making – from therapeutics for degenerative eye diseases, to cloud computing content management, to cancer treatments and cardiac surgery solutions, to web conferencing and consumer online services.

Our firm thus has a strong interest in this proceeding and in the impact your decisions could have on the ongoing vibrancy of the venture capital and entrepreneurial sectors. In addition, we each bring to unique insights on the important task before you.

Kate is a Co-Founder and Managing Director of Scale Venture Partners and has more than 25 years' experience in technology, finance and management to her portfolio teams. Before joining

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ScaleVP (then a fund affiliated with Bank of America) in 1996, Kate was a Senior Vice President responsible for the development and launch of Bank of America's internet banking services. In addition to technology management, Kate has significant experience in corporate finance and business development. Kate is also the former Chairman of the National Venture Capital Association (NVCA), a member of its Executive Committee, and a member of the Board of SVB Financial Group, the leading bank serving the technology sector. In addition, she spearheaded the IPO Task Force, which during 2011 studied the causes of the significant decline in U.S. initial public offerings and proposed concrete solutions – now being actively considered by Congress – to restore high growth companies' ability to access public capital markets to finance their growth. As a result, she has broad and deep insights into the overall entrepreneurial ecosystem and the roles played by venture funds, banks, and others in this system.

Sharon joined Scale in 2001 and invests in mobile, internet, and enterprise software companies at Scale Venture Partners. Prior to ScaleVP, Sharon spent 15 years at Critical Path, Amplitude Software, Adobe Systems and Bain & Company. Among her varied responsibilities, she directed marketing strategies and operations, integrated product and service businesses following acquisitions, managed the application of technology to Pacific Rim and European markets, and negotiated complex intellectual property licenses. Sharon also serves on the Microsoft Venture Advisory Committee, and thus understands in a hands on way the important link between the innovation sector and more mature companies that rely on startups to enhance their productivity and provide new ideas and new opportunities for continued growth.

### **Views and Recommendations**

*First, we believe the statute gives the regulatory agencies discretion to define "private equity fund" in a way that distinguishes larger, more systemically risky funds from venture capital funds, and/or to conclude that sponsoring and investing in venture funds is a "permitted activity" under subsection (J).*

The Volcker Rule was designed to eliminate high risk investing and an increasingly "casino-like" financial sector, to use the words of its sponsors. In the statute, Congress repeatedly used the terms "hedge funds" and "private equity funds," and instructed the Council and the regulatory bodies to define these key terms. The Financial Stability Oversight Council confirmed in its Report and Recommendations that that the Agencies have authority, under the statute, to refine the definition of covered funds.<sup>1</sup> It is important that the Agencies adopt definitions that make sense, in light of both the language of the statute and its underlying purposes.

Venture capital investments are fundamentally different from the types of short term, risky, highly leveraged investments and trading activities the Volcker Rule was designed to address. Venture funds are long term structures, with lives of ten or more years. They invest in private companies, usually in original issue securities, not in public markets. Each investing fund typically owns only a minority stake in each underlying portfolio company. Venture investors typically hold each portfolio company investment for many years and work actively alongside management to build the company and transform it from a concept into a successful enterprise. Venture funds typically do not use (and are not allowed under the terms of their agreements with

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<sup>1</sup> Financial Stability Oversight Council, "Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds," page 62 and note 12 (January 2011).

their 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. Similarly, portfolio companies typically use only minimal leverage, to meet operating expenses and not as a form of financial engineering.<sup>2</sup> Venture investors earn their money only over an extended period of time as their portfolio companies "exit," either through an initial public offering or a sale to another company, and their limited partner investors typically cannot redeem their interests in the funds, absent extraordinary circumstances. As these factors make clear, not only *can* venture capital be distinguished from the broader private equity universe, it *should* be distinguished from private equity in order to ensure the Volcker Rule actually addresses the harms it was designed to address.

If the Agencies decline to refine the definition, they may still permit continued safe, sound investing by designating venture funds as a "permitted activity." Venture capital investments do not create risk to banking institutions or to the financial system, for the reasons discussed in this letter (in particular their size, lack of interdependence with public markets and the broader financial sector, and lack of leverage). To the contrary, they drive real economic growth and job creation; aggregate capital to fund long term investments; promote social prosperity; and facilitate the process of saving, investment, and wealth creation – all of which contribute to financial stability.<sup>3</sup> In addition, venture capital investments promote safe, effective lending, as discussed below. Having concluded that bank owned life insurance separate accounts, asset-backed securitizations, and corporate organizational vehicles all promote safety and soundness and financial stability,<sup>4</sup> we struggle to see how you could not reach a similar finding for venture funds.

*Second, we believe there is a compelling public interest in ensuring that the Volcker Rule's implementation does not needlessly restrict the amount or quality of capita flowing into high growth U.S. companies.*

As the previous paragraphs explain, the Dodd-Frank Act calls on the Agencies to adopt appropriate definitions of "private equity" and other terms in order to ensure they implement the Volcker Rule consistently with its terms and its objectives. It is critical, as a matter of public policy, that the Agencies not adopt an overly-broad definition of covered funds or sweep venture within the Volcker Rule's reach.

While the amount of capital invested in technology startups through venture firms is extremely small – roughly 0.2 percent of GDP – the returns are enormous and contribute dramatically to the strength and competitiveness of the U.S. economy. Just to provide a few statistics, venture backed companies contributed \$3.1 *trillion* of revenues in 2010, represented 21

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<sup>2</sup> In some capital intensive sectors, such as clean energy/clean technology, companies may use somewhat higher levels of debt. Even in these cases, however, debt is used as a form of non-dilutive capital to fund operating expenses and capital investments, not as a means of financially engineering returns.

<sup>3</sup> See, e.g., M. Foot, U.K. Financial Services Authority, "What Is Financial Stability and How Do We Get It" (April 2003) (citing full employment as one of four elements of financial stability); G. Schinasi, "Defining Financial Stability" (Oct. 2004) (citing the financial system's ability to facilitate the efficient allocation of economic resources as one of the core elements of financial stability, and describing a stable financial system as "one that enhances economic performance in many dimensions").

<sup>4</sup> See Notice of Proposed Rulemaking at page 18.

percent of GDP in 2010, created 11.9 million jobs, and outperformed the broader economy in terms of both employment and revenues. Venture-backed companies also create entire new sectors – from biotechnology, to cloud computing, to web based retailing, to software and hardware. Artificially restricting the flow of capital into startups will have a meaningful negative effect on our country's capacity to fund high growth companies and on our future economic growth and competitiveness.

In addition, as corporate venture investors are well aware, venture-backed startups help provide a pipeline of innovative companies that help the country's larger, more mature businesses become more productive and better able to grow. Venture-backed companies thus not only are important in their own right, but also materially affect the growth trajectory of other entities across the economy.

*Third, while a relatively small number of banks invest in or sponsor venture funds, these institutions play an important role in the innovation ecosystem and prohibiting or limiting their ability to continue to do so would be detrimental to the health of this sector.*

According to a Preqin study of venture fund limited partners, banks provide approximately seven percent of total venture investments. This is a meaningful share of the total available investment dollars, and removing that capital would harm our nation's collective ability to fund startups and drive innovation.

Some assert that other investors will step in to fill this gap. Based on our experience raising funds over the past decade and our insights into current market trends, however, we do not believe that assumption is grounded in fact. We think that the problem will be particularly acute for first time fund managers (for whom an investment from a bank that is familiar with their track record in an earlier fund or with a business can help them establish credibility with limited partners), for funds serving specialized markets (where a banking institution may have strategic alignment with the fund's investment objectives), and for funds operating in the center of the country (for whom regional banks have acted as a stable investor base and attracting investments by traditional venture limited partners can be more challenging).

In addition, banks that sponsor and invest in venture funds typically do so as part of their broader business model, in a way that strengthens the institutions and benefits their clients. During our years in this industry, we have consistently seen the contributions that the few banks that are focused on serving high growth technology companies make. These institutions, including Silicon Valley Bank/SVB Financial Group, have deep expertise and a broad array of "touch points" with both companies and funds. As a result, they are able to be consistent, stable, smart lenders, and to use their expertise to help promote their own health and growth and the health and growth of the entire technology sector. From a dollar perspective, venture investing is a small part of what they do, but it is important in deepening their knowledge base and expertise.

For all of these reasons, the Agencies should use the discretion provided to them by Congress to preserve – not restrict – the ability of banks to invest in and sponsor venture capital funds.

*Fourth, we encourage the Agencies to recognize that banks increase their alignment with their investors, reduce the risks of conflicts of interest, and promote their long term commitment*

*to creating strong, stable investments when they invest in the funds they sponsor.*

There is a perverse and contradictory provision in the Volcker Rule, which further argues in favor of continuing to oversee bank sponsoring and investing in venture funds through safety and soundness supervision rather than subjecting it to the more rigid Volcker Rule regime. Specifically, the Volcker Rule strictly limits the capital a bank may invest in a sponsored fund, capping those investments at three percent of a fund's total capital.

Yet the Volcker Rule is also intended to minimize conflicts of interest and provide incentives for banks to conduct their business in a safe and sound manner that promotes their long term growth and stability and the interests of their clients.

In the venture industry, general partners and limited partners have long believed that it is essential for general partners to invest in their funds in order to align their interests with those of their clients (the limited partners). For example, the Institutional Limited Partners Association considers it a best practice to for the general partner to have a substantial equity interest in the fund, for precisely this reason.

In contrast, when banks sponsor and invest in private equity funds, they risk conflicts because of the many ways in which they earn fees from private equity investing – as investment banking advisors to the private equity transactions and as lenders and syndication agents on the loans used to finance the transactions. In venture, in contrast, there are neither large transaction fees nor large loan origination or syndication fees.

One can trace many of the causes of the financial downturn to situations in which banks earned their income based on fees, rather than on value creation. These structures provided an incentive for the banks to increase their scale and the level of activity, whether or not those increases made sense in terms of the fundamental economics underlying the activity. Allowing banks to sponsor venture funds, but prohibiting them from investing in those funds at more meaningful levels, could create an incentive for them to drive up fund sizes and over-invest in the startup sector as a way to increase fees – despite the fact that, as the dot.com bust showed, overly frothy investing in this sector is counter-productive and can have serious negative consequences. Permitting banks to adopt more traditional fund structures – under the supervision of their regulators – maintains better alignment and helps to prevent such an outcome.

*Fifth, we encourage the Agencies to recognize that the structure of their proposed rules – in particular, their proposal on fund valuation – is at odds with sound policy. This provides another reason to avoid regulating venture funds under the Volcker Rule and to continue regulating them under existing “safety and soundness” principles.*

The proposed rules appear to require banking entities to value their investments in customer funds (for purposes of calculating the three percent limits) using the same method they use 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 have a truly perverse effect on banking entities’ ability to comply with the Volcker Rule, if that rule were applied to venture investments. It would effectively punish banks for making good investments (because they would go up in value) and reward them for making bad investments (because they would go down, providing more room for new investments). In addition,

it would create counter-productive uncertainty: a banking entity would have to decide in year one whether it could make a 10-year commitment to a venture fund, without knowing whether that fund's performance (and the performance of any other investments) over time would push it over Volcker's three percent limit. This uncertainty would hit mid-size banks particularly hard. By definition, these entities' available pool of permissible investments is significantly smaller than is true for large institutions, and their risk that a handful of strongly performing investments could push them above the limit is therefore greater.

*Finally, we believe the Agencies can rely on the SEC's definition of venture capital funds in this proceeding.*

The Agencies can draw the line they need to draw reasonably easily, by relying on the definition of venture capital set forth in Rule 203(l)-1 of the Advisers Act. In order to promote certainty (given the long duration of venture funds), a bank's investment should be characterized as a private equity investment or a venture capital investment based on the fund's stated investment strategy and its status under Rule 203(l)-1 at the time the bank makes its legal commitment to invest. In addition, banking entities should be allowed to rely on written representations made by venture capital funds regarding the fund's status under Rule 203(l)-1. Finally, banking entities should be allowed to sponsor and invest directly in venture capital funds, to sponsor and invest in funds-of-funds that invest exclusively in venture capital funds, and to sponsor and invest (directly or through a funds-of-funds) in funds that would qualify as venture capital funds under Rule 203(l)-1 but for the fact they provide loans or convertible debt (rather than equity investments) to qualified portfolio companies.<sup>5</sup>

## Conclusion

When you work with start-ups, you quickly learn that, more than anything, they need to know the rules – uncertainty can be devastating to an innovative company. We are now approaching Dodd-Frank's two year anniversary, and venture capital remains trapped in a regulatory limbo. We recognize that the Volcker Rule is a massive and complex regulation, and that the Agencies need time to develop and refine their rules. But we hope that in the very near term you will provide either a clear decision, or an interim safe harbor, that will allow banking entities to continue to make safe, sound investments in our country's startups.

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<sup>5</sup> Congress did not cover funds-of-funds or venture debt funds in the registration exemption. It was concerned that exempting funds-of-funds from registration could allow funds to structure around the registration rules, and to the best of our knowledge it simply did not consider funds that provide financing to start-up companies in the form of loans (rather than equity) when adopting Title IV. Here, in contrast, it makes sense to include both funds-of-funds and venture funds that provide loans. Both are at least as safe – and arguably safer – than direct equity funds, because funds-of-funds diversify their risk across a larger number of fund managers and portfolio companies, and because venture funds that provide financing in the form of debt rather than equity structure their investments with the downside protections typical for debt instruments. In addition, in the case of the Volcker Rule the Agencies need not be worried about funds structuring around these rules, since all banking entities' investments will be supervised and subject to the Agencies' existing regulatory authorities under safety and soundness principles.

We appreciate your consideration of our views. Please feel free to contact us if you have any questions.

Sincerely,



Kate Mitchell  
Managing Director  
Scale Venture Partners



Sharon Wienbar  
Managing Director  
Scale Venture Partners

## SCALE VENTURE PARTNERS

Name of Company	Portfolio Company Business Description
123 Signup	Provider of cost-effective, full-featured, and branded online event registration and management, online membership and association
Actiance (fka FaceTime Communications)	Unified communications, collaboration and Web 2.0 platforms
Ageia Technologies, Inc.	Physics processor unit semiconductor for gaming. Acquired by NVIDIA in February 2008.
Alimera Sciences, Inc. (NASDAQ: ALIM)	Therapeutics for degenerative eye diseases
Applied Medical Corporation	Provides innovative products that improve patient outcomes and enable the advancement of minimally invasive surgery
Arena Solutions, Inc.	On-demand bill of materials and change management software for small and mid-size manufacturers
Ascenta Therapeutics	Cancer drug discovery and development
Attensity Group, Inc.	Media insight services. Acquired Biz360, Inc., in May 2010.
Auvitek International, Ltd	High performance digital television demodulator silicon. Company was purchased by Micron (a public company) in July 2009.
Axcient, Inc.	Data protection service for business continuity and online backup
BeachMint, Inc.	Social e-commerce
Bellamax	Imaging Software Publishers
Box.net, Inc.	Cloud-based collaboration solutions
BrightRoll, Inc.	Online video advertising services
Calyx therapeutics	Small Molecule Pharmaceutical
Cardiac Pathways Corporation	Minimally invasive systems for cardiac tachyarrhythmias. Acquired by Boston Scientific in August 2001.
Collective Therapeutics	Monoclonal antibody therapies for cancer. Acquired by MedImmune in September 2005.
Converge Medical	Surgical and Medical Instrument Manufacturing
Corixa	Developer of immunotherapeutics. Acquired by GlaxoSmithKline in August 2005.
Cornice	Computer Storage Device Mfg
Cygnal	Advanced in-system programmable, mixed signal system-on-chip products and associated support tools. Acquired by Silicon Laboratories in 2003.
diaDexus (OTBB: DDXS)	Genetic biomarkers for early detection of disease
Discera, Inc.	CMOS-based MEMS oscillator technology
DocuSign, Inc.	Electronic signature platform
eGroups	Email group communication platform. Acquired by Yahoo in 2000.
Enpirion, Inc.	Semiconductors for highly integrated power management solutions
Entone Technologies, Inc.	Solutions for Hybrid TV, Connected Home and distributed video delivery
Enucia Semiconductor	Fabless semiconductor company
Esurg Holdings, Inc.	Medical and Surgical supplies to the out-of-hospital marketplace. Acquired by Henry Schein in 2007.
Eunoe	Alzheimers Medical Instrument Manufacturing
Everyday Health, Inc. (fka Waterfront Media)	Online health solutions for consumers, healthcare professionals and marketers
ExactTarget, Inc.	E-mail and interactive marketing solutions



Name of Company	Portfolio Company Business Description
FrontBridge Technologies, Inc.	Advanced e-mail protection and secure messaging services. Acquired by Microsoft in 2005.
Glu Mobile, Inc. (NASDAQ: GLUU)	Mobile entertainment publisher
Good Technology, Inc.	Enterprise-class mobile computing. Acquired by Motorola in 2006.
Horizon Pharma, Inc. (NASDAQ: HZNP)	Biopharmaceuticals for relief of mild to moderate pain
Hubspan, Inc.	Managed services for business-to-business integration
HubSpot, Inc.	Internet marketing management solutions
Innovative Micro Technology, Inc.	MEMS contract manufacturing and foundry services
Jaspersoft Corporation	Open-source business intelligence software
Liaison Technologies	Global management and B2B integration services.
Livescribe, Inc.	Paper and pen based computing platform
Lumension	Network and endpoint security solutions
MaXXan Systems	Computer Storage Device Mfg
mBlox	Mobile transaction network
Monolithic Power Systems (NASDAQ: MPWR)	Analog power management silicon for displays, digital audio, and voltage conversion
National Healing Corporation	Provides outpatient wound centers for hospitals nationwide
Ncomputing, Inc.	End-to-end desktop virtualization
Net6	Network-based application transformation gateway. Acquired by Citrix Systems in 2004.
New Century Hospice, Inc.	Provides home hospice services to (primarily) Medicare patients.
Omniture, Inc. (NASDAQ: OMTR)	Online business optimization service. Acquired by Adobe in 2009.
Oraya Therapeutics, Inc.	A medical technology company developing non-invasive, radio-surgical treatments for eye diseases
Orexigen Therapeutics, Inc. (NASDAQ: OREX)	Biopharmaceuticals for obesity
OuterBay Technologies, Inc.	Performance management for mission critical enterprise applications. Acquired by HP in 2006.
Playphone, Inc.	Mobile entertainment content delivery
Prestwick Pharmaceuticals, Inc.	Therapeutics for central nervous system disorders. Acquired by Biovail Corporation (Now Valeant) in 2008.
Rapid 5 Networks	Networking Equipment
Reply!, Inc.	Online, locally targeted marketing solutions
RingCentral, Inc.	Cloud computing based business phone system
Scale Computing, Inc.	Intelligent clustered storage
ScanSafe, Inc.	Web security-as-a-service solutions. Company was acquired by Cisco in December 2009.
Seattle Genetics (NASDAQ: SGEN)	Monoclonal antibody-based therapeutics
SGX Pharmaceuticals, Inc. (fka Structural GenomiX) (NASDAQ: SGXP)	Discovery, development and commercialization of innovative cancer therapeutics. Acquired by Eli Lilly and Company in 2008.
Siimpel Corporation	Integrated optical microsystems for digital cameras. Acquired by Tessera in April 2010.

Name of Company	Portfolio Company Business Description
Somaxon Pharmaceuticals (NASDAQ: SOMX)	Specialty pharmaceutical products to treat psychiatric and related conditions.
Sonexa Therapeutics, Inc.	Drug treatments for Alzheimer's disease and related disorders
Spinal Kinetics, Inc.	Advanced artificial disc technology
Sylantro Systems Corp.	Software platform for hosted VoIP applications. Acquired by BroadSoft in December 2008.
Teros	Web application firewall. Acquired by Citrix in 2005.
Tonic Software	Web applications management. Acquired by Altiris Inc., in 2005.
Tripwire, Inc.	Tripwire is a leading global provider of IT security and compliance automation solutions. Acquired by Thoma Bravo in 2001.
uTest, Inc.	Software testing services for businesses
Vantage Media, LLC (VM Holdings LLC)	Online performance marketing programs
Vitruv, Inc.	Technology solutions for social media marketing
Wayport, Inc.	High speed internet access for hotels, airports and retail locations. Acquired by AT&T in 2008.
Xceive	RF tuner ICs for TV sets
Zogenix, Inc. (NASDAQ: ZGNX)	Treatments for central nervous system disorders and pain.
Zone Labs	End point security solutions. Acquired by Checkpoint Software Technologies in 2003.