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"Regulating Hedge Funds and Other Private Investment Pools"

Testimony of:

Trevor Loy,

Flywheel Ventures

Santa Fe, New Mexico

Introduction

Chairman Reed, Ranking Member Bunning, and members of the Committee, my name is Trevor Loy and I am the founder and a general partner of Flywheel Ventures, a venture capital firm based in Santa Fe, New Mexico with offices in Albuquerque and San Francisco. Flywheel invests in seed and early stage companies based on innovations in information technology and the physical sciences. We invest primarily in the Southwest and Rocky Mountain regions of the U.S. in companies targeting global markets in digital services, physical infrastructure, energy and water. Since raising our first fund in 2002, we have grown to a staff of seven with approximately $40 million dollars under management in 3 active funds. Our firm targets initial investments of $100,000 to $1 million into private, start-up companies which are often built around innovations coming out of the region's research universities, R&D organizations, and national laboratories. Our goal is for these companies to one day become viable, market-leading public companies or be acquired by larger corporations so that their technologies can reach millions of people.

In addition to my responsibilities as a venture investor, I am also a member of the Board of Directors of the National Venture Capital Association (the NVCA) based in Arlington, Virginia. The NVCA represents the interests of approximately 460 venture capital firms in the United States which comprise more than 90 percent of the venture industry's capital under management.

It is my privilege to be here today to share with you, on behalf of the industry, the role of venture capital investment in the financial system, particularly as it relates to systemic risk. Our asset class is unique in many ways, with a critical distinction being that while the companies we have funded have had a proven and profound positive impact on the U.S. economy in terms of job creation and innovation, our specific asset class remains a small cottage industry that poses little, if any, risk to the overall financial system.

As Congress and the Administration examine the forces that led to the financial markets crisis, including regulatory weaknesses that may have slowed an earlier response by the government, we appreciate the opportunity to be part of the discussion. Our goal is that the role of the venture capital industry in the economy be clearly understood. We also appreciate the opportunity to offer recommendations on how regulators can meet transparency needs by using information already disclosed by venture firms, while also protecting the continued ability of venture firms to create companies and grow jobs for the U.S. economy.

The Fundamentals of Venture Capital Investment

I would like to begin with a brief overview of the structure and dynamics of venture capital investing. Venture capital funds typically are organized as private limited partnerships. Generally, 95 to 99 percent of capital for the venture fund is provided by qualified institutional investors such as pension funds, universities and endowments, private foundations, and to a lesser extent, high net worth individuals. These investors, referred to as the limited partners (LPs), generally seek the high risk/high reward exposure afforded by venture capital as a relatively small component of a diversified investment portfolio. The venture capitalists that make investment decisions on behalf of the fund form the general partner (the GP), and we supply the rest of the capital for the fund from our own personal assets. Importantly, the capital supplied to a venture capital fund consists entirely of equity commitments provided as cash from investors in installments on an as-needed basis. Although venture capital funds may occasionally borrow on a short-term basis immediately preceding the time when the cash installments are due, they do not use debt to make investments in excess of the partner's capital commitments or "lever up" the fund in a manner that would expose the fund to losses in excess of the committed capital or that would result in losses to counter parties requiring a rescue infusion from the government.

A venture fund is typically structured with a fixed term of at least 10 years, sometimes extending to 12 or more years. At the outset, a limited partner commits a fixed dollar amount to the fund. Pending the draw down of the limited partner's cash when the venture capitalist has identified a company or idea in which to invest, the cash remains in the LPs' control. The "capital calls" for investments generally happen in cycles over the full life of the fund on an "as needed" basis as investments are identified by the general partners and then as further rounds of investment are made into the portfolio companies. As portfolio company investments are sold in the later years of the fund - when the company has grown so that it can access the public markets through an initial public offering (an IPO) or when it is an attractive target to be bought - the liquidity from these "exits" is distributed back to the limited partners. The timing of these distributions is subject to the discretion of the general partner, and limited partners may not otherwise withdraw capital during the life of the venture fund.

Once the venture fund is formed, our job is to find the most promising, innovative ideas, entrepreneurs, and companies that have the potential to grow exponentially with the application of our expertise and venture capital investment. Often these companies are formed from ideas and entrepreneurs that come out of university and government laboratories – or even someone's garage. Typically, the venture industry has focused on high technology areas such as information technology, life sciences, and more recently, clean technology. Some of our recent investments at Flywheel include MIOX Corporation and Tred Displays both based in Albuquerque, New Mexico. MIOX solves one of the world's most pressing problems, the need for clean and safe water. MIOX's patented technology purifies water beyond EPA standards in over 1,300 installations around the world. The advantage of MIOX's solution, which was originally developed with funding from Los Alamos National Laboratory, is eliminating chlorine and all other dangerous and costly chemicals from the water purification process. Tred Displays is another company in Flywheel's portfolio. Much of the world's printed signage is now changing to digital technologies such as LED or LCD displays, both of which are expensive and consume tremendous energy. The Tred sign provides similar digital capability with its proprietary innovative technology that uses batteries or solar cell energy to power digital content, cutting the energy consumption of a digital sign by more than 95%.

Once we have identified a promising opportunity, we vet the management team and conduct due diligence research on the company, the market, the financial projections, and other areas. For those companies who clear this investigation, we make an investment in exchange for equity ownership in the business. Importantly, investments into start-up companies are structured as cash in return for an equity share of the company's stock. Leverage is not part of the equation because start-ups do not typically have the ability to sustain debt interest payments and often do not have collateral that lenders desire. We also generally take a seat on the company's board of directors. We expect to hold a typical venture capital investment for 5 - 10 years, often longer and, since the technology bubble burst, rarely much less. During that time, we continue to invest additional capital into those companies that are performing well; we cease follow-on investments into companies that do not reach their agreed upon milestones. Our ultimate goal is what we refer to as an exit – which is when the company is strong enough to either go public on a stock market exchange or become acquired by a strategic buyer at a price that ideally exceeds our investment. At that juncture, the venture capitalist "exits" the investment, though the business continues to grow. Essentially we make way for new investors who may be the public (when the company issues an IPO) or a new corporate owner (when there is an acquisition). The nature of our industry is that many companies do not survive, yet a few companies are able to generate very significant returns.

Our industry is no stranger to technological and entrepreneurial risk. At least one third of our companies ultimately fail, and those that succeed usually take 5-10 years to do so. In many ways, our industry is one of the only asset classes with the long-term patience and fortitude to withstand the high rates of failure among start-up businesses. This high tolerance for risk, however, is limited entirely to the operational success or failure of the start-ups in which we are owners. This risk is very different from the systemic risk that is the basis for the recent SEC registration proposals. Because there is typically no leverage component between the VC fund and its outside investors or between the VC fund and the companies in which we invest, venture capital investment risk is contained and measured. Those portfolio companies that succeed do so in significant ways, counterbalancing the losses elsewhere in the portfolio, while losses do not compound beyond the amount of capital committed by each partner. The venture industry has operated under this risk-reward model for the last 40 years.

The Economic Contribution of Venture Capital

Historically, venture capital has differentiated the U.S. economy from all others across the globe. Since the 1970s, the venture capital community has served as a builder of companies, a creator of jobs, and a catalyst for innovation in the United States. According to a 2009 study conducted by econometrics firm IHS Global Insight, companies that were started with venture capital since 1970 accounted in 2008 for 12.1 million jobs (or 11 percent of private sector employment) and $2.9 trillion in revenues in the United States in 2008. Such companies include historic innovators such as Genentech, Intel, FedEx, Microsoft, Google, Amgen, and Apple. Our asset class has been recognized for building entire industries including the biotechnology, semiconductor, online retailing, and software sectors. Within the last year, the venture industry has also committed itself to funding companies in the clean technology arena which includes renewable energy, power management, recycling, water purification, and conservation. My partners and I are extremely proud of the work that we do each day because we are creating long-term value for our investors, our companies, their employees, and the communities in which our companies operate. In fact, a 2007 study by the NVCA found that New Mexico was the fastest growing venture capital economy in the country in the past decade. We are also dedicated to playing an important role in our country's economic recovery.

Venture Capital and Lack of Systemic Risk

In light of the financial meltdowns of the past year, we believe that Congress has a right and duty to examine regulatory policy to protect investors from systemic risk. However, the venture capital industry's activities are not interwoven with U.S. financial markets. We believe an examination of any of the measures of size, complexity, or interconnection reveals that venture capital investment does not qualify as posing such risk for the following reasons:

Venture capital firms are not interdependent with the world financial system. We do not trade in the public markets. Most venture capital funds restrict or prohibit: (i) investments in publicly traded securities; (ii) investor redemptions prior to the end of the fund's term (which, in most cases, is ten to twelve years); and (iii) short selling or other high risk trading strategies. Moreover, our firm stakeholders are contained to a defined set of limited partners and their interests in the funds are not publicly traded. LPs make their investment in a venture fund with the full knowledge that they generally cannot withdraw their money or change their commitment to provide funds. Essentially they agree to "lock-up" their money for the life of the fund, generally 10 or more years as I stated earlier. This long-term commitment is critical to ensure that funds are available not just for the initial investment into a start-up, but also for the follow-on rounds of investment which provide the company continued resources to grow. LPs agree to this lack of liquidity because the venture industry has historically achieved higher returns than the public markets. However, the length and risk profile of the investment also means that LPs typically limit the amount of money that is dedicated to venture activity. A pension fund, for example, typically will only invest 5-15% of its investable assets in what are called alternative assets – the broad category of hedge fund, private equity, real estate, and venture capital investments. The percentage or component of that allocation that is then committed to venture investing is often quite small.

Whereas a hedge fund in distress may leave a chain of unsettled transactions and other liabilities, a venture capital fund in distress would generally only have consequences limited to the investors' returns, the fund sponsor's inability to raise a subsequent fund, and the fund's portfolio companies potentially losing access to additional equity capital. With its relatively small allocation to venture, the totality of the capital at risk is known and transparent, bounded by the level of capital initially committed.

The venture capital industry is small in size. While certain pooled investment funds may present a systemic risk due in part to their size, the same cannot be said about venture capital funds, as the collective venture industry equates to a fraction of other alternative asset classes. In 2008, U.S. venture capital funds held approximately $197.3 billion in aggregate assets. That same year, U.S. hedge funds held, in the aggregate, approximately $1.3 trillion in assets[1]. From the period 2004 to 2008, only thirteen (13) U.S. venture capital funds had $1 billion or more in commitments. In comparison, approximately 218 U.S. hedge funds held over $1 billion in assets in 2008 alone. In 2008, venture capitalists invested just $28 billion into start-up companies which equates to less than 0.2 percent of U.S. GDP. The average size of a venture capital fund in 2008 was $144 million dollars, although areas such as cleantech and biotech investing are very capital intensive and often require larger funds.

Venture capital firms do not use long-term leverage or rely on short-term funding. Borrowing at the venture capital fund level, if done at all, typically is only used for short-term capital needs (pending drawdown of capital from its partners) and does not exceed 90 days. In fact, many venture capital funds significantly limit borrowing such that all outstanding capital borrowed by the fund, together with guarantees of portfolio company indebtedness, does not exceed the lesser of (i) 10-15% of total limited partner commitments to the fund and (ii) undrawn limited partner commitments. Additionally, venture capital firms do not generally rely on short-term funding. In fact, quite the opposite is true. Our firms gradually call down equity capital commitments from investors over a period of approximately ten years on a "just-in-time basis," with initial investments in a company typically made within the first three to five years.

All risk is contained within the venture ecosystem of limited partners, venture capital funds, and portfolio companies. This ecosystem differs significantly from others where leverage, securitization or derivatives are used. For example, a million dollar mortgage can create a

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[1] *See* Hedge Fund Intelligence Ltd., *United States: the end of an era? Global Review 2009,* GLOBAL REVIEW 2009 (January 2009) (available at http://www.hedgefundintelligence.com/Article.aspx?Task=Report&IssueID=71697&ArticleID=2186589).

multiple of asset flows – perhaps $100 million – because of derivatives and bets regarding interest rates for that mortgage pool. In our world, a million dollar investment is just that – a million dollars. There is no multiplier effect because there are no side bets or other unmonitored securities based on our transaction. When one of our companies fails, the jobs may go away and our million dollars is gone but the losses end there. Even when certain industries broadly collapsed in the past – such as the optical equipment industry – the failure and losses remained contained to that industry and those investments. Although entrepreneurs and their companies were impacted, the impact remained a very isolated, non-systemic exposure. Without the layer of securities or use of derivatives that were at the heart of the many problematic transactions that catalyzed the recent financial crisis, the financial pain of failure remains self contained. No outside parties are betting on the success or failure of the venture industry and therefore they can not be impacted.

Risk is very much at the heart of the venture industry but it is entrepreneurial and technological risk not systemic financial risk. Indeed, it is critical that our country proactively support this entrepreneurial risk as it has translated into new companies, millions of jobs, and countless innovations that would otherwise never be brought to life. As the fundamentals of our industry are expected to remain unchanged, we do not believe that we will find ourselves in a position to contribute to any systemic risk going forward.

Meeting the Need for Transparency

As I stated at the outset, we do recognize the need for transparency into our activities and, in that spirit, venture firms have provided information to the SEC for decades. We believe this information remains sufficient to meet the need for transparency without burdening our firms with additional regulations that do not further the understanding of systemic risk. I would like to take a moment to review our current disclosure activities.

As limited partnership interests are securities, venture capital fund offerings must either be registered with the SEC or meet an exemption from registration proscribed by the Securities Act of 1933 (the Securities Act). Venture capital funds typically rely on the Rule 506 “safe harbor” of Regulation D, as an exemption from publicly registering their securities with the Securities and Exchange Commission (the SEC).

To comply with the Rule 506 safe harbor, most venture capital funds file a “Form D” disclosure document with the SEC during or shortly after their offering has commenced. The Form D requires disclosure of significant information about the private offering.

An initial Form D must be filed with the SEC no later than fifteen calendar days after the “date of first sale” of securities in the venture capital fund’s offering. Any information contained in a Form D filing is publicly available. As part of the current Form D filing requirements, venture capital funds are required to disclose many aspects of their business that can assist the government in assessing whether or not the venture capital fund imposes any systemic risk to the financial system.

Form D currently requires venture capital funds to disclose information about the fund, including (i) the fund’s name, (ii) principal place of business, (iii) year and jurisdiction of organization, and (iv) the form of legal entity. Form D also requires venture capital funds to disclose material information regarding the size and terms of the offering. This information includes (i) the date of first sale of the fund’s securities, (ii) the intended duration of the fund’s private offering, (iii) the minimum investment amount accepted from a third party investor, and (iv) the total number of accredited and non-accredited investors to which the fund has sold securities (a Form D amendment is required if the total number of non-accredited investors increases to more than 35). This information also discloses the relevant Securities Act and Investment Company Act of 1940 exemptions that the fund relies upon in privately offering its securities.

A venture capital fund must also disclose the total dollar amount of securities the fund is offering. In contrast to hedge funds and some other types of pooled investment funds, a venture capital fund offering is generally neither continuous nor for an indefinite amount of interests. The stated offering amount is also often disclosed in the venture capital fund’s offering memorandum or in the limited partnership agreement among the limited partners and general partner of the fund.

Additional SEC Registration Requirements Could Hamper Venture Activity

The SEC previously used the Investment Advisers Act of 1940 (the Advisers Act) as a mechanism to attempt to regulate hedge fund activity. It is important to note that the SEC also explicitly exempted venture capital activity from that regulatory push. We strongly believe that the government’s need to understand the venture industry’s financial commitments can be met with current disclosure. Using the Advisers Act brings layers of additional regulatory requirements that can prevent us from focusing our time and financial resources on helping to start and grow new companies, does not provide the government with meaningful insight into systemic risk assessment and will divert government resources.

A venture capital firm employs a small administrative staff to handle firm operations. Often an investing partner will take on the role of Chief Administrative Officer and in that capacity will manage a Chief Financial Officer. The CFO is fully engaged in the financial operations of the firm, including portfolio company reporting, and all investor relations activities. At Flywheel, we have a single full-time Director of Finance and Operations. This individual, who I proudly note has been honored as one of the top CFO's in our region, manages all aspects of our quarterly and annual financial reporting, our portfolio company reporting, our relationships with our tax, audit, accounting and legal service providers, our investor relations, our capital management, and other miscellaneous financial activities. In addition, as a small firm, her responsibilities also encompass general management and office management duties, including seemingly mundane activities such as booking travel, filing expense reports, and coordinating team logistics. By requiring venture funds to ***register*** with the SEC under the Advisers Act, the administrative burden on the firm and the CFO would grow exponentially. In addition to filing information regarding the identification of the firm, its partners and assets under management, the Advisers Act establishes a number of substantive requirements that would change the operation of a venture fund and the relationship between the venture fund and its limited partners. Many of these requirements, which are summarized below, would demand significant resources and overhead which sophisticated investors have not requested and venture funds currently do not have in place.

SEC Examinations **--** The SEC can and does conduct periodic examinations of registered investment advisers. The SEC inspection staff looks closely at, among other things, the firm's internal controls, compliance policies and procedures, annual review documentation, and books and records. SEC examinations may last anywhere from a few days to a few months. The intent of these inspections is to evaluate the firm's compliance with various policies and procedures imposed on registered advisers. We do not believe that requiring periodic inspections of venture capital firms would provide meaningful insight for the government's assessment of systemic risk; however, we do believe it would further divert the SEC's resources from inspection of firms that do present systemic risk. Moreover, the costs and administrative burdens associated with preparing for an examination can be substantial.

Performance Fees: The Advisers Act prohibits contracts that provide for compensation based on a percentage of the capital gains or capital appreciation in a client's account, subject to certain exceptions, including a provision that permits a performance fee to be charged to certain "qualified clients" of the adviser that have a minimum net worth or a minimum amount of assets under management with the adviser. This limitation was designed to preclude advisers from subjecting client funds and securities to unnecessary speculation in order to increase fees to the adviser. However, venture firms are intentionally structured to make investments in companies that may fail and requiring venture firms to register could unintentionally prohibit carried interest payments for certain investors, thereby denying them access to a high-growth alternative asset class. In particular, it would require significant restructuring issues for existing funds formed in reliance on existing exemptions. More fundamentally this restriction alters the long-standing practice of LPs providing increased incentives for the GP to demonstrate long-term commitment to company growth. Doing so could change the dynamics of the industry unnecessarily.

The following administrative requirements, while not controversial, would require venture firms to dedicate resources beyond those which their investors have asked them to devote:

Compliance Programs and Appointment of Chief Compliance Officer: The Advisers Act would require venture firms to implement written policies and procedures designed to prevent violations of the federal securities laws, to review the policies and procedures annually for their adequacy and the effectiveness of their implementation, and to designate a chief compliance officer (a "CCO") to be responsible for administering the policies and procedures. The CCO selected by the venture firm must be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. The SEC has indicated that it expects that written policies and procedures would address, at a minimum (i) portfolio management processes; (ii) trading practices; (iii) proprietary trading of the adviser and personal trading by the adviser's supervised persons; (iv) accuracy of disclosures made to clients, investors, and regulators; (v) safeguarding of client assets; (vi) accurate creation and maintenance of required books and records; (vii) advertising and marketing practices; (viii) processes to value client holdings and assess fees based on those valuations; (ix) safeguards for the privacy protection of client records and information; (x) disaster recovery and business continuity plans; (xi) insider trading safeguards; and (xii) anti-money laundering efforts.

Codes of Ethics: The Advisers Act would require venture firms to adopt a code of ethics (a Code) which must set forth, among other things, (i) standards of conduct expected of personnel; (ii) a system of pre-clearance for investments in initial public offerings and private placements, (iii) a requirement that all violations of the Code be promptly reported to the CCO or his or her designee; and (iv) a requirement that certain advisory personnel periodically report their personal securities transactions and holdings in securities. As venture capital funds do not typically trade in the public markets and generally limit advisory activities to the purchase and sale of securities of private operating companies in private transactions, the latter requirement is of limited relevance to venture capital funds, yet would still apply.

Reports in relation to securities holdings must be submitted to the CCO on an annual basis; reports in relation to securities transactions must be submitted on a quarterly basis. The adviser must provide each supervised person with a copy of its Code and must obtain each supervised person's written acknowledgement of receipt of the Code, as well as any amendments.

Form ADV and Periodic Filing: The Advisers Act would require a venture firm to file Form ADV Part I with the SEC in order to become registered under the Advisers Act. In addition, all registered venture firms would need to furnish each limited partner or prospective limited partner with a written disclosure statement that provides information concerning the venture firm, its operations, and its principals. This would need to be done on at least an annual basis.

Custody: The Advisers Act would require a venture firm that has custody of limited partner funds or securities to maintain such funds or securities with a qualified custodian. If a venture firm has custody of the limited partner funds or securities, then the firm must send quarterly account statements directly to each limited partner, member, or other beneficial owner. However, the venture fund need not send these quarterly account statements if such entity is subject to audit at least annually and distributes audited financial statements to all limited partners. In the alternative, a venture firm possessing custody may also have an independent public accountant verify the assets held by the firm at least once a year. This auditing procedure must be conducted on a surprise, rather than a scheduled, basis.

Recordkeeping: The Advisers Act sets forth the books and records investment advisers must maintain. The CCO and at least one member of the professional staff of a venture firm would have to be fully familiar with this rule, which lists approximately 20 categories of records to be maintained, and with all operating procedures for complying with the recordkeeping rule. Generally, a registered investment adviser's books and records must be kept for a total period of five years (and longer in some cases).

All of these compliance elements promise to be costly from both a financial and human resources perspective. They also promise to change the way venture capital firms operate, adding significant administrative burden in exchange for information that is neither relevant nor useful for measuring and managing systemic risk.

We have been in this place before. In 2001, then President Bush signed into law the USA Patriot Act, broad legislation intended to combat terrorism and money laundering activity. The legislation imposed anti-money laundering ("AML") compliance obligations on "financial institutions," including broker-dealers, commodity trading advisors, commodity pool operators, and investment companies. While the term "investment companies" was not specifically defined, most legal opinions concluded that the term was intended to encompass both registered investment companies (e.g., mutual funds) and private investment funds (e.g., U.S. and offshore unregistered hedge funds, funds-of-funds, commodity pools, private equity funds, and venture capital funds).

In addition to complying with existing AML requirements such as reporting currency transactions and complying with the economic sanctions imposed by the U.S. through the Office of Foreign Assets Control ("OFAC"), the new statute imposed significant new obligations, including designating a compliance officer, establishing ongoing training programs and arranging independent audits to ensure compliance.

However, as the regulatory process unfolded, the Treasury Department ultimately recognized that venture activity did not meet the criteria for money laundering risk. The Treasury concluded that funds which do not permit investors to redeem investments within two years of their purchase would not be required to comply with the USA Patriot Act's AML compliance program obligations. In this instance the regulations were tailored to meet the need for information and transparency while not affecting activity ultimately unrelated. We hope that the Congress and the Administration will work together with our industry to ensure a similar outcome in the current regulatory overhaul.

Summary

We understand that the implosion which occurred in the financial system in the last year – and the economic strife which ensued – is a just reason to examine how to better protect investors and the overall market. We agree that those entities and industries which could cause financial system failure should be better monitored so that the events of 2008 are never repeated. However, venture capital is not one of those industries. Our size and operations within the private market do not pose broader financial risk. Venture capital played no role in the recent financial meltdown and does not have the fundamental investing principles to cause a future financial system failure. By requiring the venture industry to comply with the requirements of the Advisers Act, Congress would be unnecessarily weighing down an asset class that should be focused on building companies and creating jobs, rather than re-directing our resources and time toward administrative functions that our investors did not request and that do not help the entrepreneurs that we fund to create valuable businesses and the jobs that follow.

For innovation and entrepreneurship to continue to succeed in the U.S., the venture capital industry needs a supportive public policy environment. In many areas we acknowledge and are thankful for a public policy framework in the U.S. that not only supports our industry and our entrepreneurs but remains the envy of the rest of the world. As a small and dynamic industry, however, we remain highly susceptible to seemingly minor changes in our ecosystem. While some larger asset classes may be able to absorb the proposed regulatory costs and requirements, I am here today to say that the venture industry – and subsequently the start-up economy – will not go unscathed by the contemplated regulatory changes. We ask that you please examine each asset class that will be impacted by this legislation and make your policy decision based upon the systemic risk posed by each as well as the implications of regulation, and focus the government's resources where it can have the most impact. We believe you will come to the same conclusion: venture capital does not belong in this mix. I thank you for your consideration today and I am happy to answer any questions.