U.S. House of Representatives Committee on Financial Services
October 6, 2009
Hearing on
"Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office"

Testimony of:
Terry McGuire
Co-Founder and General Partner, Polaris Venture Partners,
Waltham, MA
and
Chairman of the National Venture Capital Association

Introduction

Chairman Frank, Ranking Member Bachus, and members of the Committee, my name is Terry McGuire and I am a co-founder and a general partner of Polaris Venture Partners, a venture capital firm based in Waltham, Massachusetts with additional offices in Seattle, Washington. We founded Polaris in 1996 with a mission to identify and invest in exceptional entrepreneurs and operating companies with innovative ideas and the promise to become market leaders. Since its inception Polaris has invested in more than one hundred companies in the areas of information technology, life sciences, digital media, and consumer and business services. Today we are actively nurturing more than 90 companies. Our entire organization employs 53 people of which 20 are venture investors. Even at this modest size, we are considered one of the larger venture firms in the industry.

At Polaris we build companies by actively partnering with each entrepreneur and management team to help propel their ideas into market leading businesses. We do this by providing a small amount of capital and a large amount of operating expertise and strategic counsel over a long period of time. While providing capital is the first order of business, it is the least time consuming of all our activities. We also recruit and attract employees at all levels. We identify and structure strategic partnerships. We raise additional equity to help the company make it to the next milestone. And, we're available 24/7 to support great teams, solve problems, identify opportunities, and detect "land mines." We also take a long-term view of our partnerships, knowing that building a successful company from the ground up takes time. We provide access to Polaris' expertise and network at all stages of a company's development and across all strategic areas of the business. And while we bring our own unique expertise and culture to the table, my firm operates under the same long-term principles that all venture capital firms do in the United States. The venture industry has been doing business this way for more than 50 years.

In addition to my responsibilities as a venture investor, I am also Chairman of the Board of Directors of the National Venture Capital Association (the NVCA) based in Arlington, Virginia. The NVCA represents the interests of more than 400 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. While it is our steadfast position that the venture capital industry poses no systemic risk to the world financial markets or to retail investors, we understand the need to identify and address the causes that led to the recent financial crisis. Further, we recognize the importance of eliminating regulatory gaps so that our country is never "surprised" by massive financial failures again.

Last week Capital Markets Subcommittee Chairman Paul Kanjorski released a discussion draft focusing on risk related to private pools of capital. We would like to express our sincere appreciation for the work of the Subcommittee and the full Committee under the leadership of Chairman Frank in drafting legislation that recognizes that venture capital firms do not pose systemic risk as well as understanding the burden that Advisers Act registration would place on our industry. The direction given to the SEC to "identify and define the term venture capital fund and provide an adviser to such fund an exemption from the registration requirements" offers welcomed assurances that we will be able to continue to build companies and create jobs without major encumbrances to that process. We are extremely encouraged by the understanding this Committee has demonstrated for the differences between entrepreneurial and systemic risk and we look forward to working with Congress, the Administration and the SEC to implement the recommendations put forth in the draft legislation.

The venture capital industry is committed to being part of the solution. To that end, today I will provide assurances and support to this Committee's draft legislation as to 1) why the venture capital industry does not create systemic risk, 2) why the government must continue to embrace entrepreneurial risk, 3) how sweeping venture capital into the originally introduced regulatory proposals would have been harmful to our industry and economic growth, and most importantly

4) how we might work within the framework of your legislative draft to achieve transparency and oversight without burdening our asset class.

Venture Capital Investment Overview

The contained structure of a venture capital fund, the long term nature of our investments, and the straightforward cash for equity model make our asset class unique. Venture capital funds typically are organized as private limited partnerships. Generally, 95 to 99 percent of capital for the venture fund is provided by accredited institutional investors such as pension funds, universities and endowments, private foundations, and to a lesser extent, high net worth individuals who seek the high risk/high reward exposure afforded by venture capital. Venture capital funds are <u>not</u> sold directly to retail investors like mutual funds. The only means in which a retail buyer can have access to a venture fund is through a pension fund where venture capital might comprise a very small percentage of a fully diversified investment portfolio.

Our investors, referred to as the limited partners (LPs), commit to our fund a fixed amount for a fixed term of at least 10 years, sometimes extending to 12 or more years. During that time, the venture capitalists that make investment decisions on behalf of the fund form the general partnership (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. Venture capital funds 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. In fact, most limited partnership agreements, ours included, prohibit us from any type of long term borrowing.

All committed capital remains in the LP's control, until the venture capitalist has identified a company or idea in which to invest. These "capital calls" for investments happen in cycles over the full life of the fund on an "as needed" basis. 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. As an example, one of our recent investments at Polaris is Pulmatrix based in Lexington, Massachusetts which is further developing novel technologies out of the labs at MIT and Harvard to treat, prevent and control the spread of highly contagious respiratory diseases such as H1N1.

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 that 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. In fact most of our companies are not profitable and require our equity to fund their losses through their initial growth period. 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 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. The liquidity from these "exits" is distributed back to the limited partners. At that juncture, the venture capitalist "exits" the investment, essentially making way for new public investors (when the company issues an IPO) or a new corporate owner (when there is an acquisition).

Our industry is no stranger to technological and entrepreneurial risk. In fact, our business model – and our success – is built on embracing this type of risk. At least one third of our companies ultimately fail, and those that succeed usually take 5-10 years to do so. Our industry is one of the only asset classes with the long-term patience 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 is not financial engineering; this is straightforward equity investment and partnering with management to build a company

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 50 years.

The Economic Contribution of Venture Capital

The venture capital industry has contributed disproportionately to US economic growth and historically has differentiated the US economy from all others across the globe. Since the 1970's, 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, Medtronic and Apple. At Polaris, we have seen many of our companies go public including Akamai, which pioneered Internet content delivery in the late 1990's and today employs more than 1600 people and delivers 15-20 percent of all web traffic.

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. Personally, as an investor in the life sciences arena, I am extremely proud of the work that I do each day, even knowing that not all my companies will succeed. Because the ones that do – the ones that have succeeded, have created jobs, generated revenues, and literally saved lives. Innovation and technology are critical to our economic future and the venture capital industry is committed to playing an important role in continuing our leadership in this arena.

Venture Capital and Lack of Systemic Risk

Since the financial crisis occurred, proposals before Congress rightly sought to protect investors from systemic risk. This Committee, through its legislative draft, has taken the lead in demonstrating an understanding that the venture capital industry's activities are not interwoven with U.S. financial markets and should not be regulated in the same manner as other asset classes that may indeed create such risk. Below is an analysis of the areas of systemic risk identified by the Treasury Department along with an explanation as to why venture investing does not contribute to this threat.

Venture capital firms are not interdependent with the world financial system. We do not actively trade in the public markets. Most venture capital funds restrict: (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. 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.

Venture capital funds are not directly available to retail investors. The Advisers Act and the Investment Company Act apply primarily to the retail mutual fund sector and are both designed primarily for retail investor protection in individual accounts that invest in publicly-traded stocks and bonds. Unlike mutual funds or hedge funds, individual investors do not have direct access to venture capital funds. The one exception to this rule are high net worth individuals who comprise less than 10 percent of our institutional investor base and must be accredited to gain access to our funds. And while pension funds are often institutional investors in venture funds, their exposure is extremely small as these institutional investors are limited, in some cases by law, to 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 quite small.

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. This figure is expected to decrease in 2009. As a comparison, in testimony delivered earlier this year in the Senate, Mark Tresnowski, Managing Director and General Counsel of Madison Dearborn Partners speaking on behalf of the Private Equity Council, noted that the private equity industry has more than $450 billion in committed capital waiting to be invested. In the first quarter of 2009, the U.S. hedge fund industry held approximately $1.33 trillion in assets[1]. In 2008, venture capitalists invested just $28 billion into start-up companies which equates to less than 0.2 percent of US GDP. The average size of a venture capital fund in 2008 was $144 million dollars, an average fund level which we expect to continue to decline over the next several years.

Venture capital firms do not use long term leverage, rely on short term funding, or create third party or counterparty risk. Again, from previous testimony submitted by the buy-out industry, the typical capital structure of the companies acquired by a buyout fund is approximately 60% debt and 40% equity. In contrast, 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. Not only are our partnerships run without debt but our portfolio companies are usually run without debt as well. Start-ups generally cannot take on debt even if they wanted to do so – they simply don't have the collateral to acquire debt and many don't have any revenue from which to make debt payments. Additionally, venture capital firms themselves 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.

[1] *See* Senate Banking SubCommittee Testimony of Jim Chanos from the Coalition of Private Investment Companies,*" Regulating Hedge Funds and Other Private Investment Pools",* July 15, 2009

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 and or securitization or derivatives are used. 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.

For example, a million dollar mortgage can create a 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 or telecom industries – 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.

Lastly, it should be noted that during the recent financial crisis, the venture capital industry, though not immune to the recession, outperformed all major indices. According to Cambridge Associates, the one year return for pooled venture capital ending March 31 2009 was -17.5 percent, compared to -32.9% for the NASADQ, -35.9% for the DJIA, and -38.1% for the S&P 500. Anecdotally, at Polaris, our collective portfolio had consistent revenue growth during the financial crisis. Thus, while the venture industry was impacted tangentially by the recession, our companies exhibited a stronger buoyancy than the overall market. This phenomenon is not inconsistent with historical performance of our asset class.

Additional SEC Registration Requirements Would Hamper Venture Activity

We appreciate the implicit acknowledgement by this Committee that SEC registration is not just filling out a form and submitting it annually. The Investment Advisors Act of 1940 requires the creation of a substantial infrastructure which will easily cost small venture firms hundreds of thousands of dollars each year. The additional regulatory requirements will 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 Polaris, our CFO John Gannon is, in our opinion, one of the most qualified financial professionals working in the venture capital industry today. He previously was a manager with PricewaterhouseCoopers and the CFO of publicly traded company. As General Partner, John also sits on 5 portfolio company boards, offering his financial expertise to grow these fledgling businesses. In addition to John, we have a finance staff of four. Yet even with these highly qualified individuals, we are still stretched thin and would need to add additional resources to meet SEC Advisers Act registration requirements. And, please remember that Polaris is viewed as one of the larger venture firms in the United States.

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.

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 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. The costs will impact all venture firms in a negative fashion but will hit smaller firms the hardest as they typically do not have the financial or human capital today to comply with these requirements. These smaller firms are often located in regions of our country without a large venture presence like Georgia, Idaho, Michigan, Wisconsin, Ohio and Florida. Whereas in other industries, larger firms might view regulation as a competitive opportunity to weed out smaller players, the venture industry depends on the viability of firms of all size for a thriving ecosystem. We applaud this Committee for recognizing the human and financial costs for all our firms and assert that the direction provided in the legislative draft has gone a long way towards assuring the ongoing viability of these important company builders.

Meeting the Need for Transparency: A Proposal

The venture capital industry has always recognized the need for transparency into our activities and, in fact, we have provided information to the SEC for decades. I would like to take a moment to review our current disclosure activities, and then offer a proposal for consideration by the SEC for an enhanced process that seeks to address the concerns of policy makers.

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 latter and invoke Rule 506 "safe harbor" of Regulation D, as an exemption from public registration. To comply with the Rule 506 safe harbor, most venture capital funds file a "Form D" disclosure document with the Securities and Exchange Commission (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.

While we believe the Form D filing to be sufficient to determine the lack of systemic risk from venture capital firms, we also understand the concern expressed by the Administration that the financial system overhaul must protect against what has been called "regulatory arbitrage"—where industries seek to exploit regulatory gaps. Therefore, we put forth that the information we provide with slight modifications could easily be sufficient to meet these additional needs *without* burdening our firms with additional regulations that do not further the understanding of systemic risk. Our proposal is as follows:

Currently on Form D, question 4 asks the type of fund being raised, with options listed as "venture capital," "private equity fund," "hedge fund," or "other." If the "venture capital" box is selected, we could then file, on an annual basis with the SEC, a supplemental form – call it D-2 – that answers the administration's questions on the elements of systemic risk: the use of leverage, assets under management, trading positions and counterparty obligations. For pure venture capitalists, this form would be simple to complete as we do not use leverage, don't have counterparty obligations, and only have trading positions if we are fortunate enough to have a company that has just successfully completed an IPO and we have not yet been released from the post-IPO lock-up to sell that stock.

The D-2 solution is a preferable option because it does not require the SEC to derive and test a complex definition of venture capital investing. Rather it allows firms to first define themselves, but then be confirmed as "safe from systemic risk" by responding to questions that reveal the nature of the investing activity rather than relying on nomenclature alone. Firms engaging in systemically risky activities will quickly be identified by the SEC. Regulators would also enjoy the efficiency of the form, following up only with those firms which indicate they are engaged in activities that contribute to systemic risk. This process would accomplish the Administration's stated goals of providing transparency and eliminating regulatory gaps without unnecessarily burdening the venture firms or the SEC, as full blown SEC registration would do.

The Committee's support of exempting venture capital from regulatory proposals is backed by precedent. 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 Senate and the Administration will follow this precedence and the recommendations of this Committee and work together with our industry to ensure a similar outcome in the current regulatory overhaul.

Commitment to Effective Implementation

Along with our expressed appreciation for this Committee's thoughtfulness with regards to the treatment of venture capital in this legislation, we would like to convey a commitment to implementation. As we know from past experience, time can create uncertainty and completing the legislative and regulatory process on financial services will not be simple. We are ready to assist policy makers in expediting the process so that a regulatory policy can be effectively and efficiently implemented for venture capital funds, all in the best interest of investors, entrepreneurs and regulators.

Summary

We applaud this Committee's recognition that venture capital did not contribute to the implosion that occurred in the financial system in the last year, nor does it pose a future systemic risk to our world financial markets or retail investors. Requiring venture capital firms to comply with the Advisers Act would have unfairly burdened our industry with significant processes and costs redirecting our limited resources from finding and building new businesses to administrative tasks. We are hopeful that the Committee's intent to protect entrepreneurial growth and innovation is shared by the full House, the Senate, and the SEC as the legislative process moves forward.

The venture capital industry supports the government's request for greater transparency into what we do and how we do it so that policy makers can achieve the necessary comfort level that no gaps exist in our regulatory ecosystem. We believe that an enhanced reporting mechanism such as the form D-2 process we've described will provide the necessary assurances ongoing without burdening our small asset class.

The venture capital industry has benefited from many public policies that support entrepreneurs and create a positive environment for company growth. We have also struggled at times with the unintended consequences of the casting of a wide net which was not meant for us. We are grateful that this Committee has chosen the former with regards to this legislation.

At a time when economic recovery is paramount, we must all focus on the task at hand. Embracing entrepreneurial risk has created tremendous economic growth for our country. We stand ready to work with you so that you can gain the transparency you require without hurting our industry and the start-up companies with whom we work so closely. I thank you for your consideration today and I am happy to answer any questions.