Master thesis

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The Impact of Post-Financial Crisis Regulations on U.S. Venture Capital

An overview and in-depth analysis of new regulations affecting the venture capital industry in the United States.

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Abstract

This thesis takes a closer look at the regulations implemented after the latest financial crisis in the United States, will study their respective characteristics and impact on the venture capital industry. In order to analyze these (new) regulations, the reader will first be provided with a short explanation of venture capital and an overview of the financial crisis and its causes. By dissecting the Acts, their goals, requirements and the obligations that (will) affect the venture capital industry, will be distilled and explained. After examining the available facts, figures and opinions of various authors, fund managers, investors and other members of the venture capital industry, the impact of these Acts on the VC industry will be outlined and commented. This thesis concludes by summarizing the goals, intentions, effects and results of the Acts. Additionally, the writer will give his opinion on these acts and provides the VC industry and U.S. Government with advice on ways to prevent, evade, mitigate and/or avoid any unwanted effects these Acts might induce.

In response to the financial crisis the U.S. Government has implemented two major new Acts that will reform the financial system; the Dodd-Frank Act and the JOBS Act. For the VC industry, these Acts will impose new obligations but also create new opportunities. Additionally, a new act is to be expected that will tax carried interest as income, instead of taxing it under the capital gain tax.

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Abbreviations

ADS	Average Deal Size
AUM	Assets Under Management.
IPO	Initial Public Offering
Fed	Federal Reserve
LLC	Limited Liability Company
LP	Limited Partnership
M&A	Mergers and Acquisitions
MBS	Mortgage Backed Security
NVCA	National Venture Capital Association
PE	Private Equity
ROI	Return On Investment (Efficiency of an investment as a percentage of the initial investment. (ROI = Gain from investment – cost of investment / cost of investment))
SEC	Securities and Exchange Commission
SME	Small and Medium Enterprise
TARP	Troubled Asset Relief Program
U.S.	United States
VC	Venture Capital

1. Introduction

This first chapter will be an introduction to the main aspects of the thesis. Section 1.1 will provide the reader with a brief overview of the current discussions and developments occurring in the VC industry. The objective of this thesis and the problem formulation are discussed in section 1.2. In the final section of this introductory chapter, section 1.3, the theoretical framework will be set out to delineate the scope of this thesis.

1.1 Current development and discussions

During the last five years, the majority of the world has been in financial turmoil leading to crashing stock-markets, a sharp decline in consume wealth, mass layoffs, an increase in the number of bankruptcies and a near collapse of the European currency. The VC market, a largely unstructured and unregulated market with little oversight, has also been affected by the economic crisis.

Since the start of the financial crisis in 2008, governments and other legislators have been introducing and implementing new regulations across the financial market(s) trying to minimize (systemic) financial risks to their national economy and thereby to the global economy.[1] Mainly in the U.S., home of the world's largest VC market, legislators were quick to respond to the financial crisis. As is custom in a response to a crisis, policymakers created cross-sector regulations for financial institutions, trying to prevent the crisis from happening again. Faced with an increase in regulations and policies, the affected sectors will try, and have tried, to argue why the regulations and policies will not have the desired effects. And that the increased costs resulting from these regulations and policies will lead to the 'downfall' of the sector. Ultimately, the Dodd-Frank Act, JOBS Act and other regulations have been or will be implemented to (partially) regulate VC firms and create a limited amount of Government oversight of the industry. All the parties involved have an opinion as to why and how the industry should be regulated. Opinions vary from;

[1] Author's note: It could be argued that the financial crisis has started (much) earlier. For this thesis, we will study the impact of the financial crisis on the venture capital industry, which resulted in a decrease in 'Average Deal Size' and IPOs only since early 2008.

misunderstanding the VC industry as a whole and its relation to the crisis, right up to the destruction of the industry due to regulations.

In addition to being the subject of new regulations and policies, the VC industry is struggling to reproduce the profits that were being made before the internet-bubble. The underperformance of the VC industry is not a new phenomenon and several VC executives have called the industry itself broken.[2] Whether or not the 'Venture Capital Circle' is truly broken remains to be seen. Fact of the matter is that the VC industry has underperformed the stock market for more than a decade.[3] Not only are investors investing less in venture capital, the VC firms themselves are having trouble to find investments. This has resulted in fewer VC firms and funds but also in an increase in capital overhang, which is uninvested capital managed by the funds. At the end of the VC-cycle, the number of exits, in terms of M&A transactions and IPOs, are also down.[4]

So why is the industry underperforming? And do the new regulations and policies have (had) any influence on the development and current state of the industry? Before these questions can be answered, first we must learn the basics.

1.2 What is venture capital? A short introduction

Venture Capital is a form of high-risk financing. As a method for (private) equity financing, the typical VC firm focuses on new and emerging and/or existing private businesses and entrepreneurs with the potential for high-growth and/or 'game-changing' innovative business ideas.[5] In addition to providing the start-up or business with financing, VC firms also provide added value in the form of legal, technical, business and marketing aids, the development of management systems and knowledge of the sector. When investing in an enterprise, the VC firm will take (a portion of) control of the business via

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[2] See S. Austin, 'Majority of VC's in Survey Call Industry Broken', *Wall Street Journal,* June 29, 2009, accessed via blogs.wsj.com.

[3] See 'We Have Met the Enemy … And He is Us: Lesson from Twenty Years of the Kauffman Foundation's Investments in Venture Capital Funds and The Triumph of Hope over Experience', *Ewing Marion Kauffman Foundation*, May 2012, p. 3, 16 & 44. Numbers are based on over 100 VC funds.

[4] See D. Cumming & S. Johan, 'Is Venture Capital In Crisis?', Exhibit 1; data from *www.pitchbook.com*, accessed via www.worldfinancialreview.com.

[5] Author's note: This depends on the firms' strategy.

management roles and board seats.[6] In some cases the VC firm even took over the board position of the original entrepreneur/inventor due to his underperformance and/or failure to lead the enterprise. The availability to capital and the support by the VC firm decreases the time the product needs to get to the market. Furthermore, the firms help improve the manner in which the product is presented to its targets. Examples of VC backed companies are; Google (Sequoia Capital, Kleiner Perkens Caufield & Byers), Facebook (Accel Partners, Greylock Partners, Meritech Capital), Groupon (Digital Sky Technologies) and many, many others.[7]

A typical VC firm will have several funds, investing in specific sectors of industry such as energy, financial, healthcare, internet, mobile, etc. Each fund will invest in several start-ups and/or innovative enterprises. After receiving the investment, these companies are called portfolio companies by the VC fund. Out of the estimated 410.000 and 550.000 businesses that start-up every year in the U.S., only a tiny percentage of these businesses will ultimately receive VC backing.[8] Most funds set up by a VC firm will have a lifespan ranging from 5-20 years. Fund lifecycles depend on many factors e.g., firm, investment size, sector, exit strategy and time it takes to dissolve the fund. Due to the nature of VC and the lifespan of a fund, venture capitalist will invest in a long-term relationship with the portfolio company. This long-term relationship enables the venture capitalist to focus on long-term profits rather than short-term gains. A typical VC backed company will not be profitable during its first years and might require additional funding for it to be financially self-sustainable and profitable. This a target may ultimately not be reached before the end of the funds lifespan. The fund will 'exit' the enterprise within the funds' lifetime via a certain strategy. The most common strategies are the IPO, merger or sale of the investment. A large percentage of the exits within VC backed companies will fail to give a positive ROI

[6] Author's note: The deal specifics between the entrepreneur/inventor and the VC firm are outlined in a term-sheet.

[7] Author's note: Information on VC-firms that backed the respective companies can be found in the Wall Street Journal and individual companies' website.

[8] See M. Doms, 'Business Startups: Why Entrepreneurs Didn't Start Up in 2009 and Why That's Likely to Change', *Census Bureau, United States Department Of Commerce: Economics & Statistics Administration*, 1980 – 2009 oversight.

to the VC fund.[9] These figures underline the risk of VC. It is therefore important, for a VC fund as well as for its firm, that the ROI from the fund's portfolio companies in total is positive in order to secure capital inflow in future funds and keep investors satisfied.

The fund's general partner(s), which usually is a legal entity, has full liability for the debts and obligations of the fund, which is usually organized as a LLC or LP. The fund will be managed and controlled by fund managers who will make investments and manage the portfolio companies as well as take care of the daily affairs. A specific fund structure and strategy will be set-out by the GP, or the managers that represent the GP, in order to determine the maximum number of investors, size of the fund, geography and sector(s) in which to invest in. Furthermore, a specific team is assembled by the managers too asses potential investments and/or to provide portfolio companies with business support. They will look for investment opportunities and/or enterprises that are not able to get funding for their growth via traditional means. The equity that makes up the funds comes from governments, investment banks, pension funds, large companies, wealthy individuals and other parties with great liquidity. These investors are referred to as limited partners. The limited partners pay an annual fee of their investment to the general partner for management fees and other operating expenses. In addition to the annual fee, the GP will receive a compensation based on the profits that the fund generates. This so called 'carried interest' incentivizes the GP to achieve a positive ROI. In the VC industry, compensation is typically paid out using a 2 percent annual management fee, based on capital committed to the fund, and 20 percents of the profits on sale of portfolio companies or closure of the fund.[10]

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[9] See D. Gage, 'The Venture Capital Secret: 3 Out of 4 Start-Ups Fail', *The Wall Street Journal*, September 19, 2012. Based on a study done by S. Ghosh, senior lecturer at Harvard Business School. The NVCA estimates that *'40 percent of venture backed companies fail; 40 percent return moderate amounts of capital; and only 20 percent or less produce high return'.* Whereas the Kauffman Foundation's data suggests that; *'80% of the funds failed to deliver returns that beat a public market by more than 3 percent annually. 62% failed to deliver return that exceed public markets, after fees and carry were paid. Almost 25% of the allocated funds still haven't been returned to the LP's after fund end-of-life, and only 4 out of 30 funds with more than $400M under management provided returns above public market.'*

[10] Author's note: Due to disappointing returns in the last decade there has been critique on this structure by the Kauffman Foundation, and others, arguing that limited partners should negotiate better deals with the general partners with regards to percentage of fees and carried interest and the way the portfolio companies are picked.

VC is generally recognized as a great job-creator. Unlike other ‘normal’ SMEs which generally comprise sole proprietorships and small local businesses with no aim to grow, VC backed companies intend to develop and grow big - fast and/or reach a large part of the market. With the help of seasoned managers and other important business aids, a VC backed company will avoid pitfalls that an organic growing company might encounter, increase its business network substantially, attract top-managers and other experienced personnel and decrease overall product development costs. All of this is supported by access to a large amount of (directly available) funds.

1.3 Objective and research question

The new regulations that have been created since the start of the financial crisis, and the impact these regulations had, have or will have on the U.S. venture capital market has been the motivation for choosing this topic. A number of venture capitalist, general managers and investors have criticized regulators that new restrictions, obligations, regulations, increased oversight and control will not prevent new financial crises and/or that the venture capital industry didn’t have any influence on the financial crisis to begin with.

The first part of this thesis will examine the new regulations and policies implemented after January 1st, 2008 that affect the VC industry. To see if these new regulations and policies had or have any positive, negative and/or unwanted effects on the VC industry, these regulations and policies, their respective goals and their intended effects will be outlined. Not implemented, but also proposed regulations will be reviewed. Additionally, this thesis will theorize their effects, by looking at specific laws, regulations, policies and governance guidelines, literature and the opinions of legislators, private parties, investors and fund managers. In order to (dis-)prove these opinions and expected effects, this thesis will take a closer look at the industry figures from the years 2008 to 2013 in order to determine if there is a link between regulatory developments and industry developments.

Finally, this thesis will conclude by summarizing these results, to analyze if the effects of post-crisis regulations and policies on the VC industry are in accordance with

their goals and targets. In addition this thesis will give recommendations on the discussed VC industry regulations and VC industry regulations as a whole.

2. Financial crisis and the state of venture capital industry[11]

In order to review the venture capital market and the influence of the financial crisis on its developments, the background of the financial crisis must be examined. Section 2.1 of this chapter will set-out the major developments of the financial crisis in three parts. Each of these subchapters will cover a certain aspect of the financial crisis. In section 2.2, the venture capital industry will be examined in detail by comparing the development of the financial crisis to developments in the venture capital industry. In the final sub-chapter of section 2.2, the financials of the US venture capital industry dating 2000 – 2013, will be analyzed to deduce industry trends and developments.

2.1 Outline of the financial crisis[12]

The financial crisis is the collective noun for the events that led the greater part of the world in an economic recession. Many countries, financial institutions, companies and citizens are still feeling the effects and/or are recovering from this crisis. Rather than investigating the aftereffects of the crisis, this chapter will take a short explanatory look at the causes of the financial crisis and its effects on the PE sector, and the VC sector in particular. As is the case with most crises, the financial crisis did not have just one cause. Several factors that eventually led to a domino-like collapse of the U.S. economy, which subsequently affected the global economy.

Late 2001, the U.S. economy began to recover from the dotcom bubble, which started only 2 years earlier. To restore fate in the market, financial institutions loaned out massive amounts of money with the idea that this increase in available (consumer) liquidity would led to greater consumer spending. Financial institutions were able to loan out large sums of money, due to the low federal funds rate.[13] Investors sought high-risk investments that would provide higher yields in order to recover from the past few years.

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[11] Author's note: This chapter entails a brief and summarized account of the crises and does not necessarily reflect any official opinion or view of the author.

[12] See 'The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States', *The Financial Crisis Inquiry Commission,* January 2011, p. 38 – 410.

[13] Author's note: Alan Greenspan, the Fed Chairman at the time was quoted saying; 'In these circumstances the committee believes that today's additional monetary easing could prove helpful as the economy works its way through this current soft spot.'

The availability of 'cheap' liquidity in the market, the short-term-profit driven financial institutions driven by profit-incentivized managers and a lack of government oversight, regulations and failing corporate governance accounted for a sharp increase in sub-prime loans and mortgages to people with 'bad' credit. This created the perfect conditions for a new crisis.[14]

2.1.1 Mortgage crisis

Consumers with bad credit where getting loans and mortgages from banks, financial institutions and other lenders, that they most likely could not (fully) repay in the future. Due to the lowering of lending standards introduced by the U.S. government, almost everybody in the U.S. could get a mortgage. Subsequently, home prices were driven up.[15] In 2004 the SEC allowed Wall Street banks unlimited leverage while the Federal Government simultaneously drastically deregulated the financial sector, and abolished state regulatory laws. The, often subprime, mortgages were bundled into MBSs and sold to the secondary market with the promise of stable returns via interest payments by the homeowners. By bundling the mortgages, the risk of defaulting homeowners was transferred from the original lenders to the secondary market. This freed up the funds at banks to provide consumers with even more loans.

MBSs which contained subprime mortgages were (falsely) being rated as 'safe' by the rating agencies. Because fund managers, investors and other MBS buyers trusted the opinion of the rating agencies they did not, and could not, assess the risk of these MBSs correctly.

When the Fed increased its interest rate again, mortgage rates rose along with it. This, and the decline in home prices, led to a default by many homeowners, since they could no longer pay their maxed out mortgage and/or sell their home to pay of the bills. Their homes were now worth less than the mortgage it was paid with. The default of these homeowners led to an increase in foreclosures, which almost five folded within 5 years.[16]

[14] Author's note: Federal Funds Rate was between 1 and 2 percent in the period Q3 2001 – Q1 2005.
[15] Author's note: The peak in 'average home-price' was Q1 2006. Data *The Economist*.
[16] Author's note: From 532.833 in 2005 to 2.871.891 in 2010. Data *RealtyTrac.*

Players in the secondary market, amongst which pension funds, private equity funds and investment banks suddenly found out that the MBSs on their balance sheet were worth significantly less than valued historically. Since these MBSs held several mortgages, the value of the individual MBS was unclear, because no one could see the risk of defaulting on the individual mortgage.

2.1.2 Banking crisis

In 1999 the Gramm-Leach-Bliley Act (GLB-Act) repealed part of the Glass-Steagall Act of 1993, allowing investment banks, commercial banks and insurance companies to consolidate and compete in their respective markets. This effectively allowed these newly formed conglomerates to take greater financial risks in sectors in which they previously could not operate (and maybe shouldn't have) with money deposited by consumers. In addition to this liberalization, the SEC amended the 'net capital rule' for certain broker dealers.[17] The Wall Street banks under supervision of the SEC could increase their leverage from cents on the dollar (1:10) to a maximum of 2 cents on the dollar for held AAA rated securities (including MBS). This led to a buying frenzy of (overrated) MBSs amongst the Wall Street banks involved. Thereby, greatly increasing their financial exposure.[18]

The risks of the mortgage crisis were spread amongst the entire economy since the MBSs were bought by everyone. When the mortgage crisis hit it became clear to investors, banks, insurance companies and all those who bought MBS, that they were not properly valued and so they had to make (huge) write-downs and write-offs on these MBSs. Attempts to re-sell the MBSs for less failed since no-one knew the real value. The revenues dried up, since the house owners representing the MBS were being foreclosed. Financial institutions began to distrust each other and stopped loaning each other money. In the absence of liquidity, all investments dried up. The slowing of the financial gears disturbed the markets and when the word spread that some financial institutions could no longer pay the interest on the huge debt they had accumulated, their clients tried en mass to withdraw

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[17] See Part II: 17 CFR Parts 200 and 240, Alternative Net Capital Requirements for Broker-Dealers That Are part of Consolidated Supervised Entities; Supervised Investment Bank Holding Companies; Final Rules, *Federal Register, Rules and Regulations*, Vol 69, No. 188, June 21, 2004, p. 34428.

[18] Author's note: The net capital rule is a requirement for qualifying Financial institutions to maintain a certain capital ratio between 'held'capital and debt.

their funds. Over the course of the night financial institutions lost all liquidity. When the sun came up on September 15, 2008 Lehman Brothers had already filed for Chapter 11. Many other U.S. banks, insurance companies, institutional investors and other financial institutions were standing at the beginning of the largest change of the financial sector since the Great Depression of 1930. As large financial institutions began to fall and the U.S. economy slowed down, the government scrambled to prevent further damage to the economy. Most notably, congress passed the Emergency Economic Stabilization Act which called TARP into life. TARP created a $700 billion fund to purchase bad-MBS from banks, privatize and recapitalize several financial institutions, privatize U.S. companies and give/paying out loan and savings(-guarantees).[19]

2.1.3 Global meltdown

The U.S. government could not prevent the crisis from infecting other economies. (U.S.) Financial institutions were spread globally. The MBS were sold globally and due to 'dollar dependency', globalization and systemic interdependency, the financial markets were to interwoven to prevent the crisis from spreading. The reasons and manners of this contagion, and its severity, have as many reasons as the crisis itself. [20] As liquidity dried up and investments halted, governments all over the world took measurements to prevent their respective economies from collapsing and accumulated large national debts for stimulus programs and the purpose of supporting and bailing out crucial institutions. This in turn led to the near bankruptcy of several European countries who could no longer pay the interest on their national debt.

2.2 Review of the venture capital market

During these economically difficult times, the U.S. VC industry encountered the same difficulties as the rest if the financial sector. In order to assess the effect of crisis on the VC industry one must compare the historic developments in the (financial) world against the

[19] See L. Wilson, 'TARP', *University of Louisiana at Lafayette*, October 19, 2012.
[20] See S.B. Kamin & L.P. DeMarco, 'How Did a Domestic Housing Slump Turn into a Global Financial Crisis?',*Board of Governors of the Federal Reserve System: International Finance Discussion Papers*, No. 994, January 2010, p. 16 – 25. Also: OECD (2012), 'Financial Contagion in the Era of Globalised Banking?', *OECD Economics Department Policy Notes*, No. 14, June.

(historic) data provided by the VC industry. In addition to studying the total investments, the industry can be studied on capital commitments, ADS, invested industries and stage of development investments. Comparing these numbers against the global financial market and by distinguishing pre- and post-crisis figures, the impact of the crisis on the industry can be evaluated. As mentioned in Chapter 1, January 1st 2008 will be used as a reference point for the start of the crisis. To place the more recent number in a historical perspective, data from 01/01/1995 – 01/01/2013 will be studied and compared.

2.2.1 VC investments

At the end of the second millennium VC investments surged. Due to the success of the internet and internet-related companies such as Napster, Netscape, Sun, AOL, E-loan, Amazon.com and many others, investors were pouring money in every internet start-up in Silicon Valley, expecting massive returns. These start-ups, nicknamed dotcoms, were being overvalued on the (stock-)market and thus generated more ROI when they went public (or sold on the secondary market). As a result of this hype many dotcoms had too much liquidity and were being poorly managed which in turn led too poor returns for the investors.[21] After the market began to correct itself in late 1999, new investments dried up as portfolio companies and public owned companies were being devalued. After 2002 the VC industry investments bottomed out after which investments started to increase slowly. Between then and 2008, the industry underwent a period of healthy stabilized growth without major fluctuations.[22] Where the VC industry primarily consisted of IT related start-ups during the change of the millennium, the collapse of the IT-bubble led to a diversification of the industry into other sectors such as alternative energy, healthcare services, b2b-services and other opportunities.[23] In this 'stable period' VC funding, investments and ADS stabilized.

During, and after the financial crisis, the U.S. VC industry investments declined and have not recovered since. All VC industry figures show a decline in investments, deals and

[21] See Prof. D.Q. Mills, 'Who's the Blame for the Bubble?', *Harvard Business Review*, May 2001, accessed via www.hbr.org.
[22] Annex 1: VC industry total investments.
[23] Annex 6: VC investments sector

exits since the beginning of the crisis. Following the struggles across the financial sector, SME lending declined by almost 9% per year since the crisis began.[24] This number would have been higher if the Government had not introduced TARP and other relief measures. The fall in SME lending caused the 'number of new business startups' do decline to a historic low, making the 'pickings more slim' for fund managers looking to invest.[25] Funding rounds were down 42% and the amount of funds raised declined. [26] Businesses, financial institutions and (institutional) investors affected by the financial crisis were reducing their interest in risky investments. The financial crisis also affected the amount of VC-exits, reducing the number of IPOs and trade sales, limiting the amount of capital that could be re-invested. In Q1 2009 investments totaled $3.847M, reaching a low not achieved since Q3 1997. Since 2009, the industry has been recovering and growing, but at a lower level.

2.2.2 A comparison; it's all in the numbers!

In order to assess the state of the VC industry, the current state of the industry should be compared to its historical developments. The effects of the internet bubble and the financial crisis can be clearly identified in annex 1, which provides an analysis of the investments of the VC industry. Studying annexes 1 - 10, we can make the following observations;

- The VC industry has not stabilized yet. 2012 and Q1 2013 show a decline in investments.

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[24] See R.A. Cole, 'How Did the Financial Crisis Affect Small Business Lending in the United States?', For *U.S. Government Small Business Administration: Office of Advocacy,* November 2012, accessed via www.sba.gov, p. 23 – 40.

[25] See 'Business Startups: Why Entrepreneurs Didn't Start Up in 2009 and Why That's Likely to Change', *United States Department of Commerce, Economics & Statistics Administration based on data from the U.S. Census Bureau,* March 23, 2011, accessed via www.esa.gov.

[26] See J.H. Block, G. De Vries & P. Sandner, 'Venture capital and the Financial crisis: an empirical study across industries and countries', *Erasmus University Rotterdam,* February 2010, p. 3 – 13.

- Historically, the VC industry has been investing significantly more dollars into companies than it has been raising from institutional investors.[27]
- The ADS is around $5 million. Although slightly affected by the financial crisis, the ADS appears to be stable.
- The financial crisis caused a drop in seed funding. Both in investments and ADS.
- During the period of the financial crisis, the number of firms sharply declined.
- According to the statistics, the net pooled return to limited partners was not affected by the financial crisis. However, due to the nature of the VC investment cycle, future returns are likely to be affected by the financial crisis.
- The difference between first time investments and exits leads to the conclusion that there are a large number of portfolio companies under fund control and/or in the 'exit pipeline'.

Regarding the decline in the number of VC funds it is not clear to attribute this directly to the financial crisis. The funds could either have gone out of business or not have been 'renewed' after their end-of-life. It is likely that in 2010 a lot of funds who were established in the vintage years 1998-2000, reached their end-of-life status. Subsequently, the state of the 2010 economy made it impossible for VC firms to renew their funds due to lack of success of the fund's manager and/or lack of capital commitments. Although the numbers clearly show that the industry has been affected by the financial crisis, it is too early to say whether or not this will also affect the corresponding vintage years in the long run.

More worrisome than the long-term effects of the financial crisis is the trend that the industry seems to be declining rather than growing. In contrast to the stock-market, which is currently breaking records, the VC industry is seeing a decline in investments and

[27] See M. Heesen, NVCA President in *Q2 MoneyTree Report from PriceWaterhouseCoopers LLP and the NVCA*, based in data provided by Thomson Reuters.

the number of deals.[28] Now that liquidity has returned to the markets, overall investments in the PE industry are up, though not in the VC industry. It seems to be that investors are shifting away from venture capital towards other (less risky?) forms of equity investing.[29]

[28] See J. Park, 'Market Meltup: S&P 500, Dow Post Record Highs; Nasdaq Ends at Best Level Since 2000', *CNBC: U.S. Market Overview*, April 10, 2013, accessed via www.cnbc.com.

[29] See 'New Private Equity Fund-Raising Is Picking Up – But So Is The Competition', based on *Bain & Company's Global Private Equity Report 2013*, April 16, 2013, accessed via www.forbes.com.

3. Post-crisis regulations in the U.S.

In response to the financial crisis, the U.S. government and various other (government) institutions proposed, implemented and imposed various policies and regulations with the goal to prevent the further collapse of the economy and future crises. The venture capital industry was affected by some of these regulations and/or policies. This chapter will provide an overview with post-crisis regulatory developments in the U.S., following the financial crisis, that affect the VC industry. In the first section, an introduction to the regulatory developments will be given along with some insight in the beliefs of policymakers and their reasons for enacting these regulations. The specific regulatory and policy changes will be set out in section 3.2. – 3.4. Due to the non-specific character of most post-crisis regulations, and laws in general, this thesis will only examine (part of) the various laws and regulations which affect(ed) the VC industry.

3.1 Introduction

In order to prevent the economy from deteriorating, in 2009 the U.S. senate began to prepare profound and far-reaching new regulations and alterations/supplementations to existing regulations. According to the legislator, the 'new financial system', should be organized by pursuing and implementing the following five objectives;[30]

i. *Promote Robust Supervision and Regulation of Financial Firms.*

ii. *Establish Comprehensive Regulation of Financial Markets.*

iii. *Protect Consumers and Investors from Financial Abuse.*

iv. *Provide the Government with the Tools it Needs to Manage Financial Crises.*

v. *Raise International Regulatory Standards and Improve International Cooperation.*

This initiative resulted in the introduction of new regulators, stricter and more extensive disclosure requirements as well as new rules and regulations.

[30] See 'Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation', *Department of the treasury*, p. 19 – 89.

3.2. Dodd-Frank Act[31]

One of the causes of the financial crisis, according to the SEC, was the lack of regulatory oversight;

> *"These rules will fill a key gap in the regulatory landscape," said SEC Chairman Mary L. Schapiro. "In particular, our proposal will give the Commission, and the public, insight into hedge fund and other private fund managers who previously conducted their work under the radar and outside the vision of regulators."*[32]

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") is a 2.300 pages long document that introduced profound changes to various Acts. It also implemented several additions and amendments to the Investment Advisers Act of 1940 ("Advisers Act). By the time these changes were implemented and the Final Rules were formed by the SEC in June 2011, VC was no longer considered to be a systemic risk.[33] Although the goal of the Dodd-Frank Act is to regulate and supervise the financial market, certain Venture Capital Fund Advisers were exempted from registration as business advisers under section 203 of the Advisers Act, thereby they evade certain supervision. Section 203(b) of the Advisers Act was replaced in favor of another definition of "advisers", which created a number of new, more restrictive, exemptions from registration under the Advisers Act. Unlike the new rules, former section 203(b)(3) of the Advisers Act exempted any investment adviser from registration if the investment adviser;[34]

(i) *Had fewer than 15 clients in the preceding 12 months,*

(ii) *did not hold itself out to the public as an investment adviser and*

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[31] See H.R.4173, 'Dodd-Frank Wall Street Reform and Consumer Protection Act', public law no. 111-203, Title IV, 124 STAT 1574 - 1630 .

[32] Author's note: quote from SEC. Director N. Schapiro at an open SEC meeting on June 22, 2011. She commented on the amendments the Dodd-Frank Act made to the Investment Advisers Act.

[33] Author's note: SEC Final Rules provides context and explanations with regards to the explanation, application and enforcement of various Acts under authority of the SEC.

[34] See 'Exemptions for Advisers to Venture Capital Funds, private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers', *Securities and Exchange Commission*, 17 CFR Part 275, release No. IA-3222; File No. S7-37-10, p. 2-4.

(iii) did not act as an investment adviser to a registered investment company or a company that has elected to be a business development company (the "private adviser exemption").

The primary purpose of Congress in repealing section 203(b)(3) was to require "advisers to private funds" to register under the Advisers Act. Under the new rules VC fund Advisers are exempted from SEC registration requirements if they solely advise VC funds with less than $150 million in AUM in the U.S. For purposes of this exemption the SEC issued new Rules to (re)define the term 'Venture Capital Fund' under Rule 203(l) of the Advisers Act.[35] For an adviser's client to fall within the definition of a VC fund, it must meet the requirements as set forth in the Final Rules:[36]

- The fund must be a private fund specified under 202(a)(29) of the Advisers Act: '*A private fund is an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940 (1940 Act), but for the exclusions from the definition of "investment company" set forth in Section 3(c)(1) or 3(c)(7) of the 1940 Act.'* Registered Investment Companies and Business Development Companies are excluded from this exemption.
- The fund must represent itself to the investing public as pursuing a venture capital strategy. According to Rule 203(1)-1(a)(1), the self-identifying use of terms like "multi-strategy fund" or "growth capital fund" does not automatically disqualify the fund under the definition. The 'representing' circumstances are determined by particular facts and circumstances. 'Investing public' can be defined as investors and potential investors. The representation of a fund does not require that the fund names itself a VC fund, but this can be part of the analysis to asses if the fund meets the 'representation requirement'. Another way for assessing 'representation' compliance is too look at all the relevant statements made by a fund to its investors and prospective investors.

[35] See Supra note 28.
[36] See M.A. Chambers, S. Rothermel, C.R. Robinson-Schepp, 'SEC Adopts Definition of "Venture Capital Fund" and Other Rules to Implement Provisions of the Dodd-Frank Act Related to Investment Advisers', *Wilmerhale*, July 12, 2011, accessed via www.wilmerhale.com.

- A qualifying fund can invest a maximum of twenty percent of its capital in assets other than qualifying investments and short-term holdings.[37] These non-qualifying assets should be consistently valued at cost or fair value. VC funds usually do not hold non-qualifying investments. Sometimes however, short-term holdings are held during the period between a capital call and funding by investors. In order to prevent abuse of this rule, the SEC defined several terms.[38]
- Fifteen percent leverage: *a venture capital fund is a private fund that does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15 percent of the fund's capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days.*[39] The fifteen percent threshold is calculated as 15% of the fund's aggregate capital contributions and uncalled capital commitments. With the exception of guarantees given by the private fund for a portfolio company's obligations, up to the value of the private fund's investment in that qualifying portfolio company.
- Private funds may not provide investors with redemption rights during the life of the fund except in "extraordinary circumstances". Whether or not specific redemption or "opt out" rights for certain categories of investors under certain circumstances should be treated as "extraordinary" will depend on the particular facts and circumstances. In Paper 17 CFR Part 275, the SEC recognizes a "*material change in tax law after investors invest in the fund, or the enactment of laws that may prohibit an investor's participation in the fund's investment in particular countries or industries*" as an "extraordinary circumstance. Unforeseeability is not a decisive factor to define these circumstances.

[37] Author's note: Rule 203(1)-1(c)(6): A qualifying fund may also invest in cash and cash equivalents, U.S. Treasuries with a remaining maturity of 60 days or less and shares of registered money market funds.

[38] Author's note: Rule 203(1)-1(c)(6); *"Short-term holdings: '… Short-term holdings are defined as cash, cash equivalents, U.S. Treasuries with remaining maturity of 60 days or less, and shares of registered money market funds.' Qualifying investments: generally consist of equity securities issued by a qualifying portfolio company where a '…qualifying portfolio company' is defined as any company that; (a) Is not a reporting or foreign traded company and does not have a control relationship with a reporting or foreign traded company; (b) Does not incur leverage in connection with the investment by the private fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment; and (c) Is not itself a fund (i.e., is an operating company)."*

[39] See Rule 203(1)-1(a)(3).

Foreseeable but unexpected events such as mergers can also qualify as an 'extraordinary circumstance'.

Another way for an adviser's client to fall within the definition of a VC fund, is if it is grandfathered. A Grandfathered VC fund is any private fund that (i) pursues a venture capital strategy and (ii) sold securities to investors unrelated to its advisers before December 31, 2010, and (iii) sold no securities after March 30, 2012. (The original registration deadline for advisers was delayed from July 21,2011 to March 30, 2012.[40]) This rule exempts all VC funds that have accepted and concluded all capital commitments, called and uncalled, by March 30, 2012 and commenced their offerings by December 2010.

A different aspect of the Dodd-Frank Act is section 619 of the Act, also known as the 'Volcker Rule'. Basically, the Volcker Rule is the (partial) re-implementation of the Glass-Steagall Act of 1933, which required banks to spin off or shut down their brokerage and investment operations. The Volcker Rule prohibits insured depository institutions (e.g. banks and credit unions), as well as their subsidiaries and/or affiliates, from engaging in proprietary trading and alternative investments, effectively separating commercial bank activities from investment (bank) activities. It also prohibits these institutions from owning, sponsoring, or having certain relationships with such investment funds. The Volcker Rule was implemented to separate the conflicting traditional banking operations from its more risky speculative investment activities in an effort to mitigate risks to (private) bank deposits. It specifies that insured depository institutions cannot hold more than 3 percent of their Tier 1 capital in private equity funds. Additionally, the Basel Agreements (I, II & III) have further tied up Tier 1 capital held by insured depository institutions. Looking at the goals of the Financial Reform Act, critics have argued that the implementation of the Volcker Rule could not have prevented the crisis, which was caused by bad mortgage loans, not trading.[41] Backers of the Volcker Rule point to the large losses investment banks and banks with large investment activities, had suffered during the financial crisis. It has not definitely been decided that the Volcker Rule will include the investing of venture capital. Though it is likely and widely expected by most institutions

[40] See 'Rules Implementing Amendments to the Investment Advisers Act of 1940', *Securities and Exchange Commission*, 17 CFR Parts 275 and 279, Release No. IA-3221; File No. S7-36-10.
[41] See S. Patterson, 'What is the "Volcker Rule"?', *The Wall Street Journal*, June 13, 2012.

that will qualify under the Volcker Rule. If so, it would prevent these institutions from investing in venture capital. Currently, their investments are largely focused on later-stage investments and in the preparation and supervising of IPOs. Qualifying institutions represent 1,5% of active US-based investors.[42] Although the Volcker Rule should have been finalized by now, the SEC and the other regulators involved, have not introduced Final Rules that will enforce the Volcker Rule.

3.3. JOBS Act[43]

The Jumpstart Our Business Startups Act (the "JOBS Act"), which was signed into law in April 2012, (will) provide(s) certain startups with the ability to raise money from "crowdfunding". Although signed into law, the SEC has yet to finalize Rules that makes it legal for companies to sell equity stakes over crowdfunding platforms.

The JOBS Act was an effort by Congress to 'legalize' and regulate the upcoming popularity of crowdfunding, and provide startups and entrepreneurs with a new way of financing their businesses. Unlike 'regular crowdfunding' which only allows investors to donate money in return for a reward, equity crowdfunding enables the startups and entrepreneurs through private placements or exempt offerings. In a time where banks and other financial institutions are reluctant to give new ventures business loans, this would enable startups to receive funding from another source than the 3 F's, angel investments, banks or VC funds. Currently, only accredited investors can engage in equity crowdfunding through licensed broker-dealers.[44] When the Rules are finalized by the SEC, Rule 506 and Rule 144A will be amended to allow 'general solicitation and general advertising in connection with offers and sales of securities made to accredited investors and persons reasonably believed to be qualified investor'. While simultaneously raising the shareholder

[42] See J. Nye, 'Implications of the Volcker Rule on venture capital investments', January 24, 2012, accessed on www.preqin.com
[43] See Public Law No.: 112-106, Act H.R. 3606.
[44] Author's note: Examples of licensed broker-dealers: SecondMarket, Microventures, Fundersclub, CircleUp, AngelList, etc.

cap. to 2000 persons, for qualified companies. However, when enacted, equity crowdfunding is limited to a certain extent and only open to;[45]

- *A private company may raise up to $1 million from equity crowdfunding, in any 12-month period by issuing restricted securities.*
- *Investors with annual income or net worth of less than $100,000 may invest no more than the greater of $2,000 or 5% of their annual income or net worth in any 12 month period in a given company, and those with annual income or net worth of more than $100,000 may invest up to 10% of their annual income or net worth annually (with at cap of $100,000 per investor, per company annually).*
- *Financial statement requirement: (1) raising amounts up to $100,000 annually requires the certification of the principal financial officer that the financial statements are true and correct; (2) amounts between $100,000 and $500,000 annually will require review by an independent public accountant; and (3) amounts above $500,000 annually will require audited financial statements.*
- *Offerings will have to be conducted through a broker or a "funding portal".*
- *Issuers may not advertise the terms of the offering other than to direct investors to brokers or funding portals.*
- *Issuers will be required to file with the SEC and provide to investors and intermediaries a range of information regarding the offering and the issuer (at least 21 days prior to the first sale to any investor and not less than annually thereafter).*
- *Securities will be subject to transfer restrictions (with limited exceptions) for one year.*

In addition to facilitating a (new) way of acquiring capital, the JOBS Act is also designed to facilitate the IPOs of smaller companies. Title I of the JOBS Act was implemented to 'reopen American capital market to 'emerging growth companies' ("EGCs")'.[46] According to the NVCA, 92% of job growth occurs after a company goes

[45] See Public Law No.: 112-106, Act H.R. 3606, Sec. 302 – 304.
[46] See Public Law No.: 112-106, Act H.R. 3606, Sec. 101 – 108.

public.[47] Studying annexes 7, 8 & 10, and comparing the number of investments to the number of exits, the IPO market is underperforming ever since the internet bubble. The Act defines EGCs as companies with annual gross revenues of less than $1 billion during their most recent fiscal year. A EGC will be continue to be deemed an emerging growth company until the earliest of:

a. the last day of the fiscal year of the issuer during which it had total annual gross revenues of $1,000,000,000 or more;

b. the last day of the fiscal year of the issuer following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under this title;

c. the date on which such issuer has, during the previous 3-year period, issued more than $1,000,000,000 in non-convertible debt; or

d. the date on which such issuer is deemed to be a 'large accelerated filer'.[48]

Smaller portfolio companies that qualify as an EGC enjoy the exemptions described in Sec. 102 of the JOBS Act;

- The ability to submit a draft registration statement for non-public confidential review by the SEC. (As long as the final submission is filed no later than 21 days before the ECG begins pitch meetings with prospective investors.);

- The exemption for providing an auditor's attestation report on its internal controls;

- Scaled-down post-IPO securities compliance and reporting obligations for the disclosure of all executive compensation information, disclosure of certain financial statements, disclosure of golden parachute agreements, etc.

- The possibility to communicate with certain institutional investors to determine whether they might be interested in a (possible) IPO before or after filing a

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[47] See M. Scogin, 'JOBS Act Impact', May 7, 2013, accessed via echanges.nyx.com.
[48] Author's note: As defined in section 240.12b-2 of title 17, Code of Federal Regulations, or any successor thereto".

registration statement in order to gauge the interest of the 'market'. (Nicknamed the 'Testing the Waters' provision.) [49]

A study researching the effects of Title I of the JOBS Act has proven that the Act is a success. Over 90% of the companies eligible to file confidentially have done so. Furthermore, companies that went public under the JOBS Act have seen an 28.9% rise from their offer price. Whether or not the total number of companies that will go public after the implementation of this Act will be structurally higher, and accordingly, the total number of IPO-exits in the VC industry will increase, remains to be seen.[50]

3.4. Carried interest taxation[51]

The carried interest, briefly mentioned in chapter 1, is the interest in future profits of the fund the GP (and thus the fund managers) receives in return for his management. Under current tax law, the income the fund manager receives from carried interest is (often) taxed at federal capital gains rate of 15%.[52] Earlier initiatives to tax carried interest at the normal federal income tax rate of 35% have failed at several occasions.

The current attempt to implement a carried interest taxation is the third attempt to do so. In 2007 Democratic Representative Levin introduced H.R. 2834 which qualified carried interest as ordinary income. After failing to be approved by Congress, in 2009, Rep. Levin reintroduced the carried interest taxation in the House of Representatives as a part of a new tax reform law. This second attempt failed to get enough support in the Senate. His most recent effort to introduce a carried interest taxation follows the presidential election campaign of 2012. Public debate sparked a new discussion after republican candidate Mitt Romney disclosed his income statement. As a former partner in Bain Capital, his income consisted for a large part in dividends and carried interest over investments, resulting in an average income tax of 14%.[53] As a result of the public outcry for the 'equality-of-taxes'

[49] See A.J. Davie, 'The Jobs Act, a Year Later – Part 2: The IPO On-Ramp', March 28, 2013, accessed via www.striclybusinesslawblog.org

[50] See O. Oran, 'IPO VIEW-U.S. Job Act companies outperform other IPOs, data shows', *Reuters,* January 25, 2012, accessed via www.reuters.com.

[51] See Bill 113-268, Cut Unjustified Tax Loopholes Act (Proposed).

[52] See Rev. Proc. 93-27, 1993-2 C.B. 343: ' the IRS will not tax the issuance of a profits interest'.

[53] See A. Bearman, 'Carried Interest Tax Legislation Won't go Away', January 23,2012, www.theventurealley.com

along with the call from wealthy industrialists, which were willing and able to pay more taxes, Levin re-introduced his carried interest proposal in the House of Representatives in 2012 under the "Carried Interest Fairness Act of 2012".

President Obama was quoted to say he 'would personally pursue a short list of tax loophole closures to try and avert looming budget cuts'.[54] In his fiscal 2014 budget proposal, the U.S. president repeated his earlier statement.[55] To realize the budget proposal, the Senate Finance Committee has appointed the tax treatment of carried interest, in their tax reform discussion paper, as a reform measure to cut the U.S. deficit by;

a. *Taxing all interest in partnerships that are received solely in exchange for services as compensation rather than capital gains;*

b. *Taxing carried interest earned by investment managers in exchange for providing services to an investment partnership as compensation rather than capital gains;*

c. *And disallow conversion of management fees taxed as ordinary income into partnership shares taxed at capital gains rates.*

In total, the Congressional Budget Office expects to raise roughly $30 billion over 10 years by closing this 'tax loophole'.[56] In the current day and age, where Congress and the Senate have agreed to reduce the U.S. deficit, it is likely that this Act will be finalized within the following years.

Although not finalized yet, the proposition has sparked quite the debate within the VC industry. Surprisingly, even L.F. de Rothschild, CEO of E.L. Rothschild, expects that the government will close the 'carried-interest loophole' and finds the current low tax rate on carried interest "outrageous".[57] On the other hand, most of the parties affected by this proposed Act will continue to argue and lobby the unjustness and harmful effects of the

[54] See K. Dixon, 'Analysis: Carried interest thrust again into tax debate', *Reuters,* February 5, 2013.
[55] See 'Fiscal Year 2014: Budget of the U.S. Government, *Office of Management and Budget,* p. 18 -170.
[56] See W. Elmendorf, 'Reducing the deficit: Spending and Revenue Options', *Congress of the United States: Congressional Budget Office*, March 2011, p. 157-163
[57] See L.F. de Rothschild, 'A Costly and Unjust Perk for Financiers', *The New York Times*, February 24, 2013.

Act, as is common with far-reaching amendments. The most compelling argument of critics of this tax-reform, is that the Act does not take in account the different components of carried interest. They argue that carried interest has two components: the return on the fund manager's financial investment in the fund (the "investment share"), and a return (the "compensatory share") on an amount invested by the limited partners that is implicitly lent to the fund manager (the "compensatory loan"). They argue that only "the investment share" is clearly a return to capital for the fund manager. Because the fund manager does not contribute any other capital, the "compensatory share" should be treated as income from labor.[58]

[58] See L. Batchelder & S. Rosenthal, Business Taxation: What is carried interest and how should it be taxed?', February 7, 2013, www.taxpolicycenter.org.

4. Analysis of the regulations

As with all regulatory amendments or implementations, they can affect anyone to whom the regulations is applicable in both a negative and/or positive manner. By reviewing the regulations, literature, expert opinions and targeted parties, the first section of this chapter will examine their respective beneficial and detrimental effects, or lack thereof. Additionally, the regulations will be reviewed to see if they are in accordance with their respective goals and produce their intended results. For a structured review, each Act discussed in chapter 3 will be reviewed separately. In Section 4.2 a prediction will be given about how these regulations will affect the VC industry.

4.1 Benefits and detriments

Before any Act is amended or implemented, industry lobbyist and other stakeholders have the chance to comment on the proposed Act or policy changes, in the hope of influencing legislators. The impact of any regulatory changes affect stakeholders that fall within the Act's reach, in ways foreseen as well as unforeseen. The general goals of the Acts (that will be) enacted by Congress following the financial crisis, were aimed at the increase in consumer protection, limiting (economic) liabilities and exposure, counteracting (economic) fraud while at the same time stimulating the U.S. economy. While the Acts set-out in chapter 3 have resulted in 'more robust supervision, the establishment of comprehensive regulation of the financial markets and risen (international) regulatory standards', it is a matter of discussion whether these Acts will truly lead to a 'more stable financial system that protects consumers and investors from financial abuse and has provided the Government with the tools it needs to manage financial crises'.[59] The opinions vary of the effects of these Acts on reaching these goals and stimulating the U.S. economy.[60]

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[59] Author's note: As set out in the objectives in the Financial Regulatory Reform paper by the Department of the Treasury.

[60] See: J. Erickson, T. Fucile & David Lutton, 'Dodd-Frank Financial Reform After 2 Years: 5 Successes and 5 Things That Will Make Our Markets Stronger', July 20, 2012, accessed via www.americanprogres.com. Also; M. Goozners, 'The Dodd-Frank Financial Reform Bill Works, But Banks Might Still Need to be Bailed Out', *The Fiscal Times*, November 10, 2011. Also; 'Financial Regulatory Reform: Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act', *United States Government Accountability Office,* January 2013. Also; M. Taibbi, 'How Wall Street Killed Financial Reform', May 10, 2012, accessed via www.rolingstone.com.

4.1.1. Dodd-Frank Act

Under the new Rules of the Advisers Act, implemented by the Dodd-Frank Act, even fund advisers that are exempt from registration need to annually file Form ADV with the SEC.[61] However, the degrees of reporting and recordkeeping requirements differ between exempted and non-exempted advisors.[62] The amendments made to the Advisers Act oblige firms and advisers (fund managers) to disclose;[63]

- *Information identifying the Advisor and/or the fund.*
- *Organizational structure of the fund.*
- *Gross asset value..*
- *Information about the fund's investors.*
- *Identification of third parties providing certain key services to the fund.*
- *Regulatory status of the fund.*
- *Investment strategy.*

The SEC has estimated that the additional costs of compliance are between $3,200 for small advisers, up to $10,400 for larger advisers.[64] These new reporting obligations do not only result in additional costs for the VC funds but can also lead to a decrease in competition within the VC industry, since form ADV is publicly available. Compliance with the exemption requirements needs to be ongoing and is so strict, that breach of any term or sum is 'punished' by loss of the exemption, resulting in a disclosure requirement of a significant amount of information. Including but not limited to; amount of assets under managements, use of leverage, trading and investments positions, types of assets held, etc.

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[61] Author's note: Form ADV is the uniform form used by investment advisers to register with both the Securities and Exchange Commission (SEC) and state securities authorities.
[62] Author's note: The difference is found to the extend that form ADV has to be filled.
[63]See A. Bearman, 'Reporting Requirements for Funds Exempted From Investment Advisers Act Registration', September 26, 2011, accessed via www.theventurealley.com.
[64] See 'Amendments to Form ADV', *Securities and Exchange Commission,* 17 CFR Parts 275 and 279, Release No. IA-3060; File No. S7-10-00, p. 84 – 88.

This is a very harsh 'punishment' for a small violation. In 2010 the average VC fund size was around $149 Million.[65] Each VC firm therefore has to weigh the additional costs of falling under the exemption against the 'benefit' of less extensive disclosure comparatively to non-exempted advisers. Nevertheless, the Dodd-Frank Act imposes increased disclosure requirements that will incur additional costs for the entire VC industry. Taking in account the goals of the Dodd-Frank Act, it does provide the regulators with more oversight.[66]

Additionally, the exemption requirements are so strict that they hinder the way the VC firms invest and they agreements they make with their investors. Rule 203(1)-1(a)(4) of the Investor Act, implemented by the Dodd-Frank Act, does not refer to the 'redemption rights provisions' stated in a term sheet, but rather to the redemption rights in an investor-fund relationship. The impermissibility of this provision in a investor-fund contract, effectively prevents investors from withdrawing capital during the life of the fund, thereby 'locking up' their investment until the end of the fund's life. Although the provision is rarely used in investor-fund contracts, it prevents the ability to make use of it in specific situations such as investor bankruptcy, or in case an unsolvable argument arises between the investor and the fund manager. The 'redemption rights rule' does not include the failure of an investor to make a committed capital call. In practice, investors and fund managers can partially circumvent the 'redemption rights rule' by implementing a 'transfer right provision'. This implies that the investor is not obliged to make a capital call in certain situations. Therefore, the legislator has to wonder whether the 'redemption right rule' should not be implemented in any other way, or dropped altogether.

Another way the Dodd-Frank Act will impact the VC industry is the implementation of the Volcker Rule. With banks as the 6th largest investor in the VC industry, representing about 7% of the total invested venture capital, the Volcker Rule would presumably lead to a large sharp decline in VC investments when (and if) implemented.[67] A hard blow to an recovering industry. When the Volcker Rule is implemented, and includes venture capital,

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[65] See S. Shane, 'Venture Capital Funds Remain Large', based on data from the NVCA Yearbook, January 11, 2012, accessed via www.forbes.com, figure 1.

[66] Author's note: But was this really necessary since the VC industry wasn't marked a systemic risk to the U.S. economy, nor is it an industry 'poluted' with fraud.

[67] See M. Dent, 'The Unintended Consequences of the Volcker Rule', January 13, 2012. Accessed via www.svb.com.

insured depository institutions will no longer be able to invest in venture capital. Currently, Venture Capital investments made by banks are mainly focused on investments in later stage companies to provide them with a loan and/or liquidity for an IPO.[68] The loss of banks and other 'insured depository institutions' would almost certainly decrease the number of (large) IPOs. Additionally, ownership of a VC fund will be prohibited. It is likely that the already decreasing number of firms/funds will reduce even further after the Volcker Rule is enacted. A number of banks have already ceased their VC activities and stopped investing and/or began to spin-out their PE groups.[69] These developments might explain the most recent decline in VC investments seen in Q1 of 2013.[70] While the 'spun-out firms' will keep investing, the inflow of equity from the banking sector will halt when the Volcker Rule is finalized and includes VC. If the Volcker Rule will not include VC, banks will most likely keep their PE groups as a subsidiary. The implementation of the Rule before the July 2014 deadline will most likely not be made due to high number of public comments on the Rule. Also, there are a great number of Acts that need to be disentangled by the regulators involved.

After the financial crisis the U.S. public cried out for more disclosure, regulation and oversight of the financial sector. By and large, the Dodd-Frank Act has achieved most of its goals, stabilized the financial sector and implemented new safeguards for the prevention of the reoccurrence of this sort of crises. With respect to venture capital, the Dodd-Frank Act has implemented stricter regulatory and disclosure requirements, in an industry where such obligations are likely to be superfluous, and hinder profitability and competition. Additionally the characterization of venture capital as a 'risky speculative activity' by the Volcker Rule, is possibly exceeding the goals of the financial reform as set out by the Department of the Treasury. This can be concluded by looking at the nature of venture capital and the disqualification of venture capital as a systemic risk by Congress.

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[68] See T. Hellmann, L. Lindsey & M. Puri, 'Building Relationships early: Banks in Venture Capital, Oxford University Press, December 17, 2007, p. 7 – 24.

[69] Author's note: Examples: Bank of America Corp., Citigroup Inc., JPMorgan Chase LLC, KeyCorp of Cleveland, Barclays and Lloyds. See; D. Primack, 'How Goldman Sachs Beat the Volcker Rule, January 22, 2013, accessed via fortune.cnn.com. And: S. Bills, 'Volcker Rule Appears Stalled – Buyouts', March 12, 2013, accessed via www.pehub.com.

[70] See Annex 1 and; The MoneyTree™ Report by PricewaterhouseCoopers and the National Venture Capital Association based on data from Thomson Reuters.

4.1.2 JOBS Act

The JOBS Act will ease regulations for qualified companies to obtain investments not only from accredited investors, but also from the 'general public' that qualifies under the Act.[71] For the VC industry, the implementation of the JOBS Act can have beneficial as well as adverse effects. Presumably, the impact of the JOBS Act will have the same impact and effects on equity crowdfunding, as regular crowdfunding did for startups. For venture capital, this development has several unintended effects.

The success of regular crowdfunding as well as the success of secondary market dealers have given VC funds an insight in the interests of the 'consumers' and a greater reach in the pool of startups. The best example is the success of the 'Pebble Watch', which failed to receive initial VC funding. Though, after a successful Kickstarter campaign, was suddenly a very popular target for VC funds. Furthermore, the figures on 'popularity' of a company on a 'crowdfunding- or secondary marketplace' are helpful in trying to determine the success of a startup product or service, resulting in more successful investments for VC funds.[72] Looking at the current trends, traditional VC business financing will shift from 'looking for a venture capitalist' and 'networking practices', too an online crowdfunding-environment where start-ups and entrepreneurs receive financing from qualified investors based on the 'popularity of their (proposed) idea or product. In terms of visibility and direct access to financing the JOBS Act will be a huge improvement over the current way of looking for VC investors or investments.[73] The fund manager seeking to invest can directly gauge the possible success of the potential investment by checking the 'popularity' of the investment.

On the other hand, equity crowdfunding would compete directly with seed (and early-stage) capital investments, forcing the VC industry to focus on later-stage investments. However, since equity investments under the JOBS Act are limited to $1 million, there would still be room for investments into startups with a higher capital

[71] See Sec. 302(a)-(6)(B) of the CROWDFUND Act. (Title III of the JOBS Act)
[72] Author's note: Examples where VC funds have invested in successful Kickstarter companies include: Oculus VR, OUYA and Brydge.
[73] See S. Case, 'Why The JOBS Act Is Good for Startups – and for America', April 4, 2012, accessed via www.revolution.com, para. 6 & 7.

requirement. Investing in later-stage companies can be less risky than investing in seed- and early-stages but the investment required is usually higher. Annexes 4 & 5 show that VC funds have already been shifting their investments towards later-stage deals, behaving more like PE firms rather than VC firms.[74] In these developed companies it is harder for a VC firm to add value to the company, develop the product and steer the company if need be, thus achieving lower returns. When investing in early-stage companies, the experienced VC firm will structure the company in such a way, the most common pitfalls will be avoided. In a later stage, it will be harder to restructure the company. Additionally, the financial risks of late-stage investing are also much lower, since the company value and (possible) profitability can be valued more clearly.

The difficulty of managing, administrating and satisfying the large number of equity investors should be noted, but it is not ours to answer, since it does not affect the VC industry. However, if the startup would receive a VC funding in following investment round, the VC fund would have to deal with all the equity shareholders. This raises a number of questions and problems. Problems that may arise are difficulties in contacting and negotiating with these parties about the terms of investing. The (possibly) high number of shareholder to negotiate with creates a lot of legal exposure for the startup as well as the investors.[75] The Sec. 4a compliance requirements for the issuers (companies) can be burdensome and the cost of which will rise with the following funding rounds.

Another aspect of the JOBS Act is Title 1 of the Act, called; 'Reopening Capital Markets to Emerging Growth Companies'. The goal is to create an 'IPO on-ramp' for smaller companies making it easier for them to go public. By reducing the costs of an IPO, which is estimated to be between $2 million and $4 million annually, it is more attractive and easier for qualified companies to raise money on the public market.[76] Profitable EGCs can now enter the public markets without having to wait for the backing (or loan) of a Bank, PE- or

[74] See S. Denne, 'HubSpot Exec Sees Late-Stage Financings Moving to Crossover Investment Funds', November 6, 2012, accessed via blogs.wsj.com. para. 2 – 7.

[75] See G. Emmanuel, '5 Reasons Why Equity Based Crowdfunding Under the JOBS Act Won't Work', February 25, 2013, accessed via www.huffingtonpost.com. Para. 4 -9.

[76] See 'Considering an IPO? The costs of going and being public may surprise you', PriceWaterhouseCooper's Deals practice, September 2012, accessed via www.ey.com, p. 4 – 30.

VC firm.[77] On the other hand, VC funds can now use the IPO on-ramp as an exit for portfolio companies that qualify as an EGC, thereby reducing the cost of the exit. 'Going Public' is the preferred way of exiting for VC funds due to the high yields that can be achieved with an IPO.[78] The implementation of the JOBS Act could lead to an increase in exits by VC funds in portfolio companies with low potential.

The goal of the JOBS Act was enacted for the express purpose of "increase(ing) American job creation and economic growth by improving access to the public capital markets for emerging growth companies".[79] Since Title III of the JOBS Act has not yet been implemented, its effects on the VC industry are currently only well-informed speculations. With regards to Title I of the Act, the results are mixed. The Act and its de-burdensome provisions have been welcomed across the market. And although the figures show that the use of 'IPO on-ramp provisions' are popular with companies going public, there has not been an increase in the total number of IPOs.[80] The real effects of Title I of the Act are probably not (yet) measurable and so the next few years will show if the Act will have any (positive) impact on the access for emerging growth companies to the capital markets.

4.1.3 Carried interest taxation

Carried interest taxation will, when implemented, affect the income of the fund managers. As with all entrepreneurs who are faced with an increase in taxes, the fund managers will pass on these extra costs on to the consumers, which in the case of venture capital, are the investors. Although not yet implemented and finalized, it is likely that carried interest taxation as income will become an obligatory practice at some point. According to the NVCA, in 2010 the average venture fund size was $149 million, which means the average annual fixed compensation component of a fund manager was almost $3 million.[81] When the Cut Unjustified Tax Loopholes Act is enacted, this will mean an average

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[77] Author's note: Annex 7, column 3 shows the number of VC backed IPOs as a percentage of the total number of IPOs.
[78] See B.S. Black & R.J. Gilson, 'Venture capital and the structure of capital markets: Banks versus stock markets', November 1997, accessed via papers.srrn.com, p. 30 – 32.
[79] Author's note: this is the title of the Act.
[80] See M. Wellington & S. Solum, 'On Its One-Year Anniversary, Two Cheers For The JOBS Act', March 28, 2013, accessed via www.forbes.com.
[81] Author's note: When using the industry wide accepted 2/20 compensation fee structure.

annual increase in 'tax costs' of $600,000 for the fund manager. While this is only a marginal figure in the light of total fund commitments, for the fund manager this is a 20% 'decrease' of his fixed compensation component. Where the other component of the compensation fee is only paid when the investments are ultimately sold.

Back in 2007, Representative Levin's goal of implementing a carried interest taxation was to create equality of tax-treatment between U.S. citizens. Since then, the proposal has failed twice. This leads us to believe that the current reason for the proposal, the 'closure of this loophole', is done for no other reason than reducing the Government's budget deficit.[82] Journalists and fund managers have indicated that they expect that the proposed Act will sort little effect, since they already figured out ways to evade the tax measure.[83]

4.2. Predictions for the venture capital industry[84]

The fall-out of the financial crisis has led, and has yet to lead, to some (major) implications for the VC industry in respect of compliance, disclosure and 'the way of doing business. While some effects of the post-crisis regulatory reforms can already being felt, other effects are too early to measure or have not yet been implemented yet.

Up to this point, fund managers have indicated that although the new regulations have led to a (small) increase in costs, it has not altered the way they do business (yet).[85] The most recent developments in the VC industry showing certain trends in industry investments. To be profitable again, VC funds have shifted their investment focus abroad in order to tap new markets. Investments have shifted from telecommunications, financial services and networking & equipment, to energy software and medical devices.[86] Another development in the VC industry is the rise in the number of public and corporate VC funds,

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[82] See M. Collins, 'Private Equity's Carried Interest Eyed by Congress: Taxes', accessed via www.bloomberg.com, para. 3 – 8.
[83] See J. Carney, 'Sorry, Mr. President, Raising Taxes on Carried Interest Won't Work', April 10, 2013, www.cnbc.com.
[84] Author's note: Based on industry developments, VC industry statistics and the opinions from journalists and venture capitalists.
[85] See N. Summers, 'Who's Afraid of Dodd-Frank? Not Wall Street', October 18, 2012, accessed via www.businessweek.com, para. 5 – 8.
[86] See Annex 6.

as well as an increase in the number of accelerators and incubators, increasing the competition for start-ups while at the same time providing start-ups with (partially) the same services.[87]

The traditional way venture capitalists conduct their business is poised to change when the JOBS Act Rules are finalized and 'carried interest loophole' is closed. The two-and-twenty compensation fee structure is already under pressure from investors.[88] This strain on the relationship between fund (managers) and investors will continue to grow due to the increased costs that will be imposed on VC funds and their managers.[89] The shift to later-stage investments means that VC funds no longer provide (high) value-adding services to portfolio companies or find jewels in the start-up market place. After all, it is easier to find (successful) later stage companies than (successful) seed companies and start-ups. Additionally, the emergence of the secondary markets and the up and coming (equity) crowdfunding market have increased the reach of investors, making it easier for them to find potential investments on their own. All of these reasons and developments will make it increasingly harder for VC funds to provide investors with a ROI that outperforms the stock market. While the competition for investments will be much higher in the future, there are still many opportunities for venture capitalists. Start-ups in certain sectors require more capital than the average investor can provide alone. Furthermore, the value added services being provided by VC are required by businesses that have huge potential, but are failing to make a profit.[90]

So is there any co-relation between underperformance of the VC industry and the introduction of new regulations? Fund performance can only definitely be evaluated at the end of its life, usually after 10 years. Under this assumption, the disappointing returns the VC industry has shown in the last few years reflect the hard times of the post-internet

[87] See B. Pearce, 'Global Venture Capital funds may turn the corner in 2013, April 4, 2013, accessed via www.ey.com.
[88] See 'We Have Met the Enemy … And He is Us: Lesson from Twenty Years of the Kauffman Foundation's Investments in Venture Capital Funds and The Triumph of Hope over Experience', Ewing Marion Kauffman Foundation, May 2012.
[89] See J. Glasner, 'LPs to VCs: Cut Fund Size, Show Us the Money and Stop Lying', PeHub, May 16, 2013, accessed via www.pehub.com, para 3 – 19.
[90] Author's note: Example: Groupon.

bubble crisis. That being said, the (financial) outlook for the VC industry is not good. A definite link between the new regulations and the underperformance of the industry cannot be proven. Considering the (new) costs of compliance and disclosure the discussed Acts will impose, they will incur only a small increase in overhead costs. However, the increase in compliance and disclosure requirements as well as the increase in competition from other parties will ultimately force the VC industry to find new ways of making money. Perhaps it is for this reason that, although they are increasing their PE investments, investors are not focussing on venture capital but rather on buyout- and real-estate investments.[91]

[91] See supra note 27.

5. Summary and conclusion

After setting out, analyzing and reviewing the post-crisis regulatory changes affecting the VC industry, a short overview and summary of the effects of the discussed Acts will be given in this chapter. In Section 5.1 a summary of the laws will be provided. A conclusion on the need of, and effects of these Acts on the VC industry will be provided in Section 5.2. Additionally, this section will briefly set-out the implications of these Acts for the VC industry. Finally, recommendations for the VC industry will be given for dealing with (the requirements of) these Acts in Section 5.3. Recommendations for the Government and regulators to achieve the goals they set out but in a more VC industry friendly way, will also be provided.

5.1 Summary

In the aftermath of the financial crisis, regulators were quick to respond with new regulations. (In some instances quicker than others.) The VC industry suddenly found itself in the crosshairs of the U.S. government due to the fact that it was an industry unknown to the public and regulators, and due to its unstructured and unregulated nature. Being disqualified as a system-risk did not prevent regulators from imposing new compliance and disclosure requirements on the VC industry. As part of a large scale regulatory reform, the Dodd-Frank Act introduced new qualifications for VC fund advisers and a new definition of a VC fund. Under the Act, qualified VC fund advisers can be exempted from certain compliance and disclosure requirements. Covered by the' VC Fund Adviser' exemption or not, the Dodd-Frank Act has imposed new obligations on VC advisers that have raised their operating expenses.

The introduction of the JOBS Act will have several effects. The primary purpose of the Act is to make it possible for 'normal people' to provide small companies in return for a equity stake. This Act will legalize and 'professionalize' a (online) crowdfunding market for investing in start-ups, up to $1 million. To prevent fraud and finance problems, the Act will impose certain conditions and requirements on the investors, brokers and companies. This Act is expected to create new competition for the VC industry. Although not yet finalized by the SEC and the other regulators involved, the Act is expected to come in effect within the

next year or so. Another aspect of the JOBS Act is the IPO on-ramp. This section of the Act should make it easier for companies that qualify under the Act to raise public money on the stock market. In order to do so, qualified companies can make use of certain beneficial provisions, giving them (more) attractive conditions to enter the market while simultaneously reducing 'the costs of going public'.[92]

The last Act discussed is in this thesis is the proposal of a carried interest taxation. Currently, the carried interest is taxed as a capital gain rather than 'normal' income. The debate in this difference in tax treatment is not a new one. The rate differential, designated a 'loophole' by President Obama, will almost definitely be 'corrected. For the VC fund manager this means a net-tax increase of 20% on their fixed compensation.

5.2 Conclusion and implications

Although the financial crisis is over and the economy is recovering, U.S. regulators are still working on reforming the financial sector and implementing provisions created in response to the crisis. The VC industry has faced some major regulatory changes. The 'Dodd-Frank Act', 'JOBS Act' and 'Cut Unjustified Tax Loopholes Act', have and/or will provide the venture capital industry with new challenges. Each of the respective tries to achieve different goals, and thus has different effects on the industry.

Together these Acts will have a great impact on the VC industry. Much will change in the next few years but the VC industry can expect the following trends (to continue):

- An increase in compliance costs and disclosure requirements across the financial sector.
- Less direct competition between funds due to the decrease in the number of (active) funds and investments.

[92] See 'Considering an IPO? The costs of going and being public may surprise you', PriceWaterhouseCooper's Deals practice, September 2012, p. 4 – 30.

- More competition from other parties such as; accelerators, incubators, corporate (VC) funds, public (VC) funds, individual (institutional) investors and other means of financing start-ups.[93]
- The principle-agent relationship between fund managers and investors will be renegotiated. Investors are becoming increasingly dissatisfied with their ROI from venture capital.
- Venture capital will focus more on later stage investing and focusing on helping companies go public, leading to an increase in the number of (VC backed) IPOs.[94]
- An increase in the reach of VC funds in finding start-ups. Nation-wide as well as globally.
- A decrease in raising venture capital and the increasingly difficulty of raising venture capital. Resulting in a (continued) decrease in venture capital investments.

The Dodd-Frank Act has certainly been a rigorous amendment to the existing rules and regulations. Looking at the goals the Government (and public) wished to achieve with the regulatory reform, the Dodd-Frank Act ticks a lot of boxes when it comes to control, disclosure and the (re)creation of a more stable financial system. With respect to the Acts who have yet to come into effect, it is impossible to say if they will achieve their goals. The success of the 'IPO on-ramp' provisions of the JOBS Act haven't led to an overall increase in the total number of IPOs yet. However, the expectations are that the on-ramp will be THE way of going public for many companies and ultimately lead to an increase is the number of 'small' companies going public. 'Equity crowdfunding' and 'equal-taxation' advocates have already deemed the respective Acts to successes. And while 'equity crowdfunding' will undoubtedly become a success, the carried interest taxation might not produce the results the government and other proponents are expecting of it. After all, Venture capitalists and

[93] See J.M. Mendoza & E.P.M. Vermeulen, 'The "New" Venture Capital Cycle (partI) – The Importance of Private Secondary Market Liquidity', Topics in Corporate Law & Economics, January 2011, available at papers.ssrn.com.
[94] Author's note: stepping into the market Banks are forced to leave.

lawyers are experts in evading (tax)regulations. Also, since the VC industry hasn't been very profitable recently, carried interest tax revenues will be disappointing. As a result of the amendment, funds might be inclined to reduce their fund size to decrease the costs incurred by taxations.

5.3 Recommendations

From the analysis of the new Acts and the provisions affecting venture capital a few things are noticeable. Following the economic and business trends and developments, certain recommendations should be made to the VC industry and the U.S. Government (regulators.)

Concerning the VC industry: Recent and future developments in (start-up) financing will force the VC industry to rethink the nature of its services and overall business model. While certainly being able to add value to businesses and the economy in general, more of their efforts should be directed towards the development of a new VC funding model. Due to the expected increase in the 'battle for seed investments' the VC investments should shift to (1) early stage companies with high capital requirements, (2) loans and investments for later stage companies (wanting to go going public) and; (3) underperforming companies in the expansion and/or later stage. Additionally, investment opportunities can be found abroad in grow markets such as the BRIC Nations and other 'developing countries' with un(der)developed finance and/or VC industries. Taking in account the recent criticism on the current compensation model for VC funds, VC firms should search for new business models to keep investors happy. This development is already taking place in the PE Industry. The VC industry would be wise to look at this sector and adopt (a) different fund and/or compensations models.[95]

Concerning the government; since the financial crisis is over, the Government should listen to the industry for ways of kick-starting and boosting the economy. Studies show that VC backed companies represented approximately 9.4% of total U.S. and 16.6% of

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[95] See 'Private Equity And Investors: Where Is This Relationship Going?', based on: Bain & Company's Global Private Report 2013, May 2, 2013, accessed via www.forbes.com, para. 2 – 5.

total U.S. GDP.[96] These facts should not be ignored. The Government should realise the current (bad) state of the VC industry and the new difficulties it is faced with. By easing certain regulations, disclosure requirements and removing administrative hurdles, the U.S. Government could reduce the industry's overhead. Another way of boosting the nation's number one job creator is by giving certain tax incentives to start-ups engaging in research and development in government prioritized sectors. Studies in other countries have shown that this would make these businesses with high capital requirements more interesting as (potential) investments.

[96] See 'Industry Overview: Venture Capital', December 3, 2012. Accessed via www.wetfeet.com.

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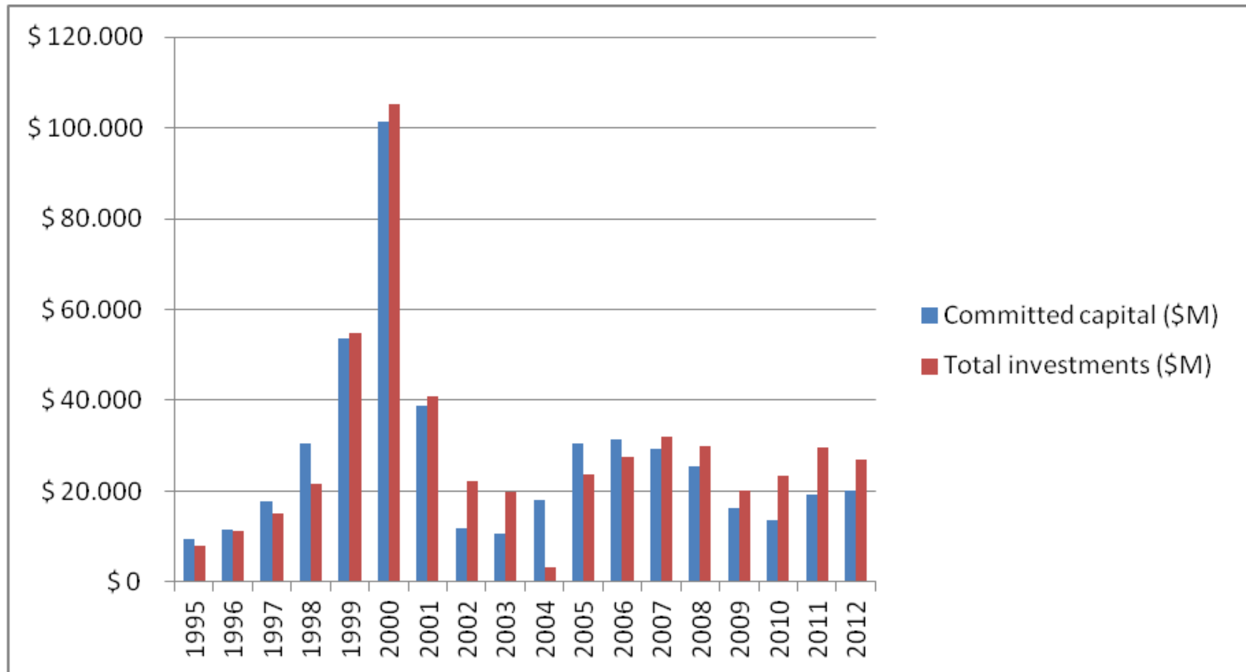
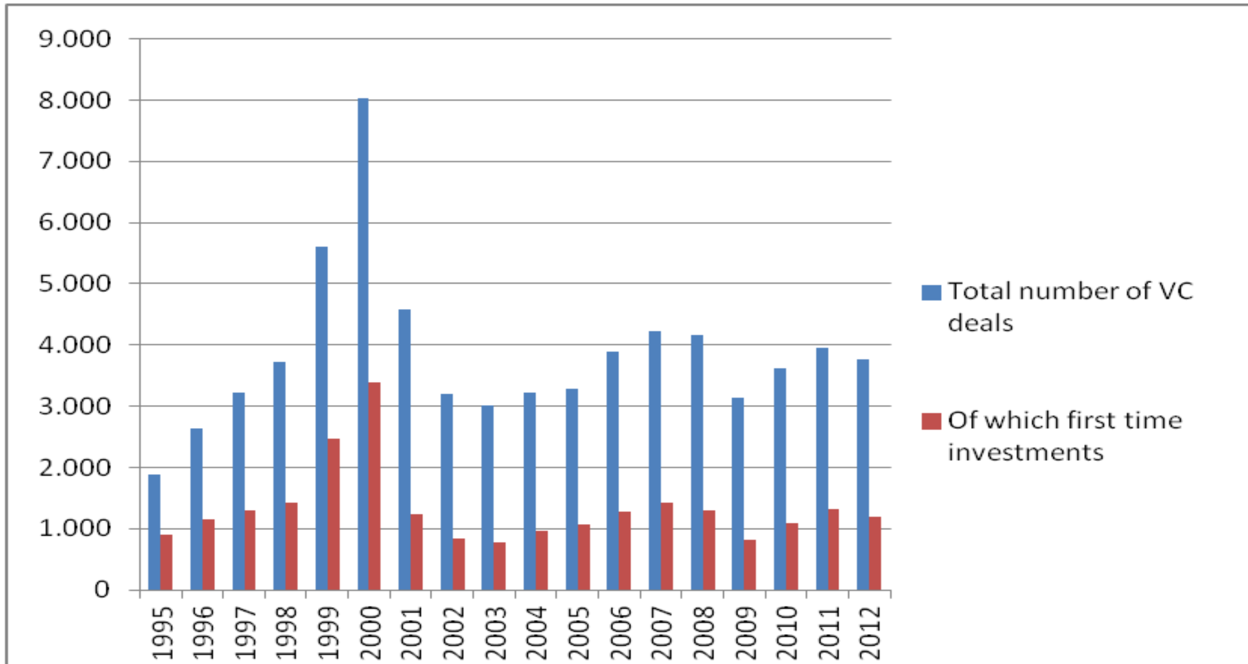
7. Annexes[98]

<u>Annex 1:</u> VC industry total investments.

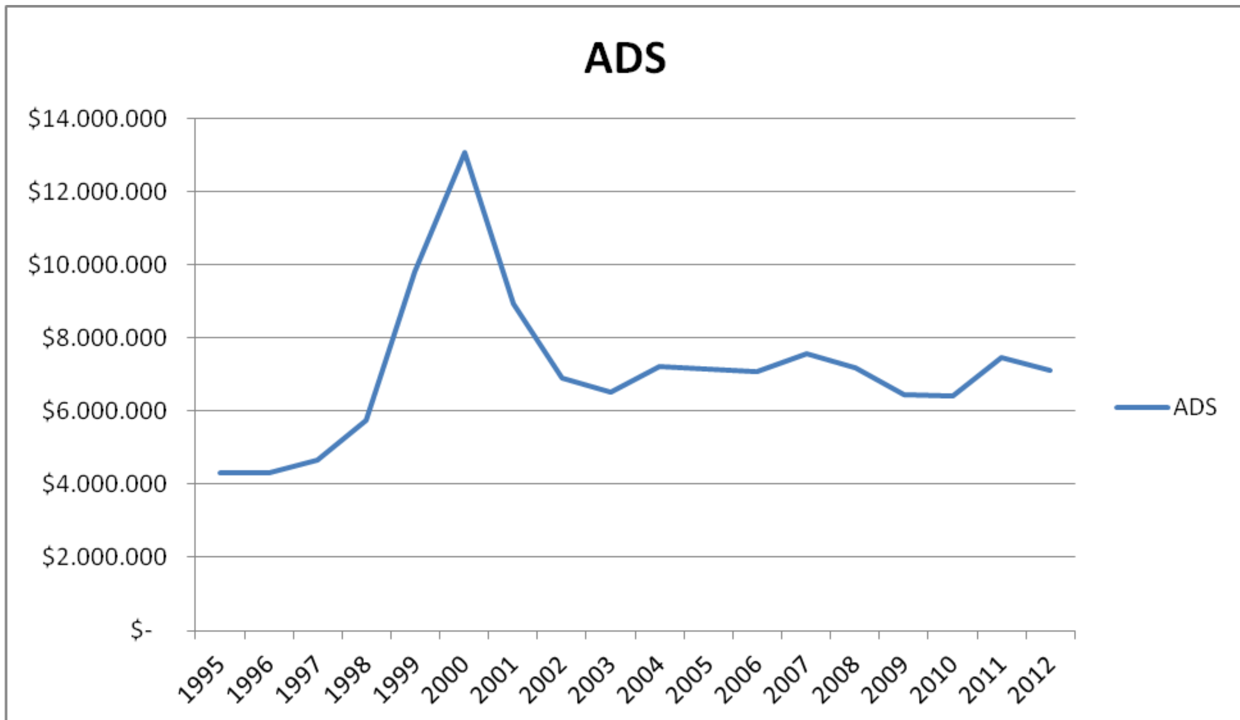


[98] The MoneyTree™ Report by PricewaterhouseCoopers and the National Venture Capital Association based on data from Thomson Reuters.

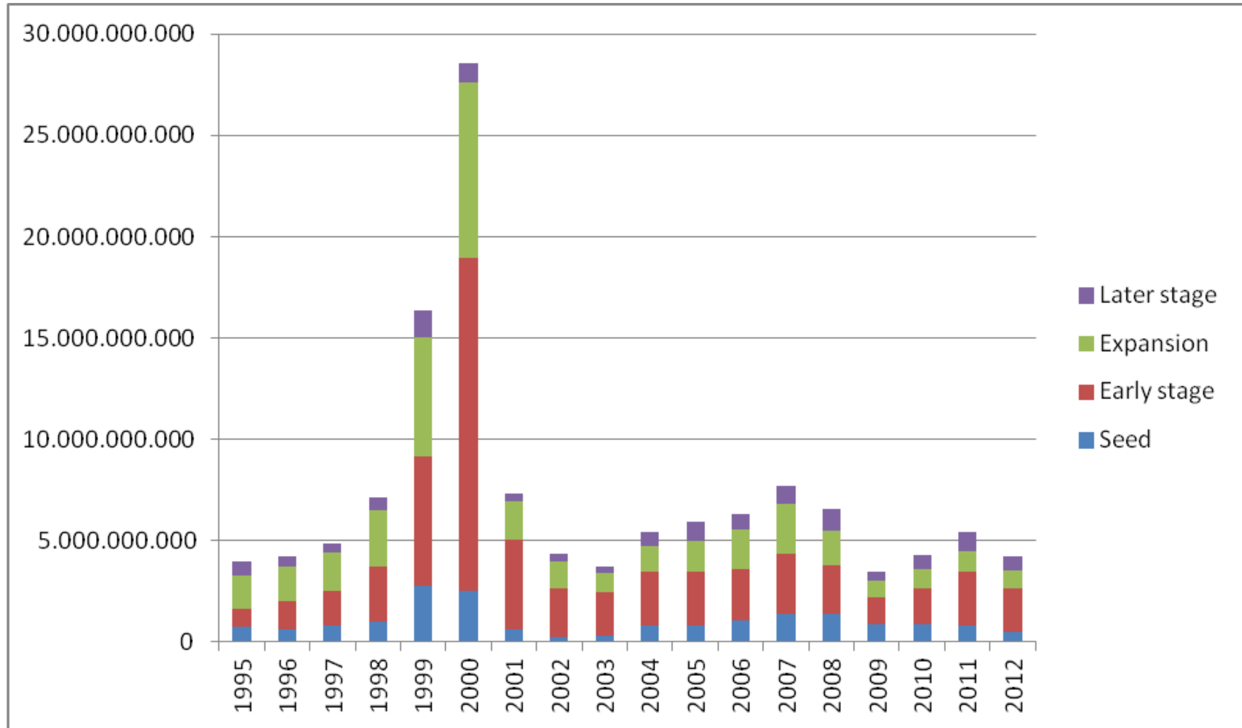
Annex 2: **VC industry total deals.**



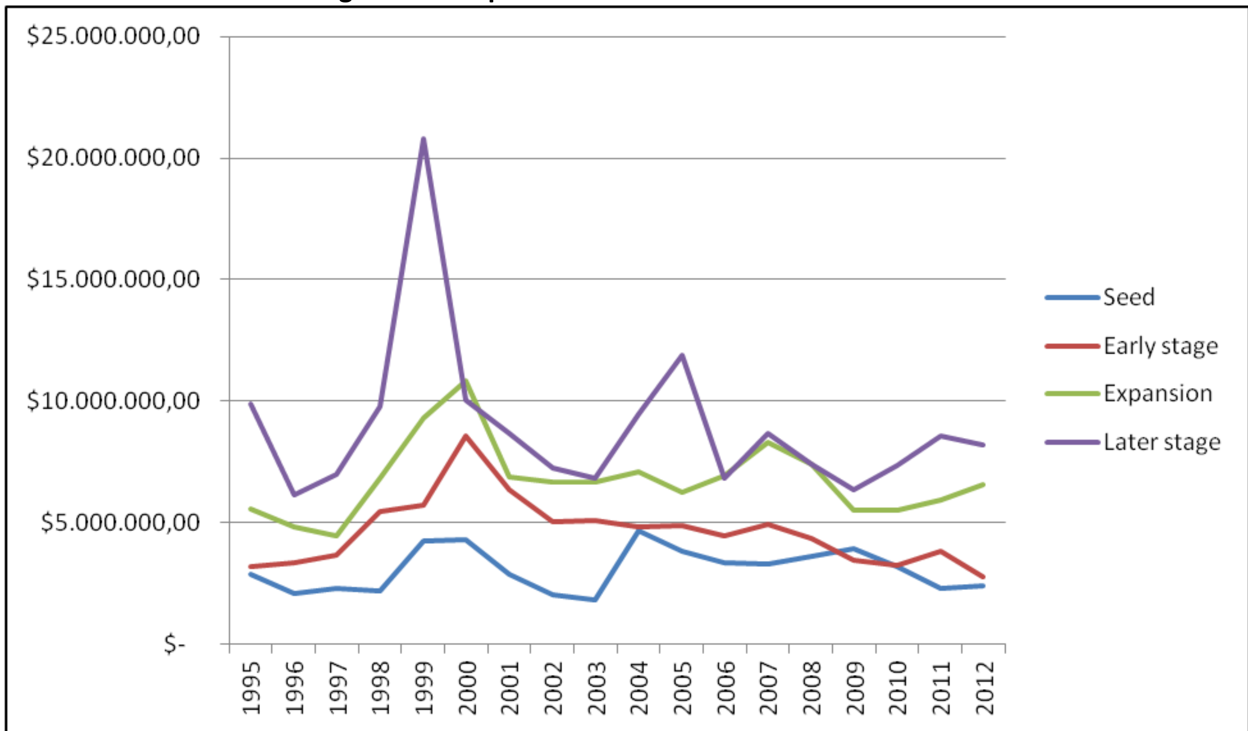
Annex 3: ADS.



<u>Annex 4:</u> First time investments by stage of development.



Annex 5: ADS in stage of developments.



Annex 6: VC investments sector.

$120.000.000.000
$100.000.000.000
$80.000.000.000
$60.000.000.000
$40.000.000.000
$20.000.000.000
$0

1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012

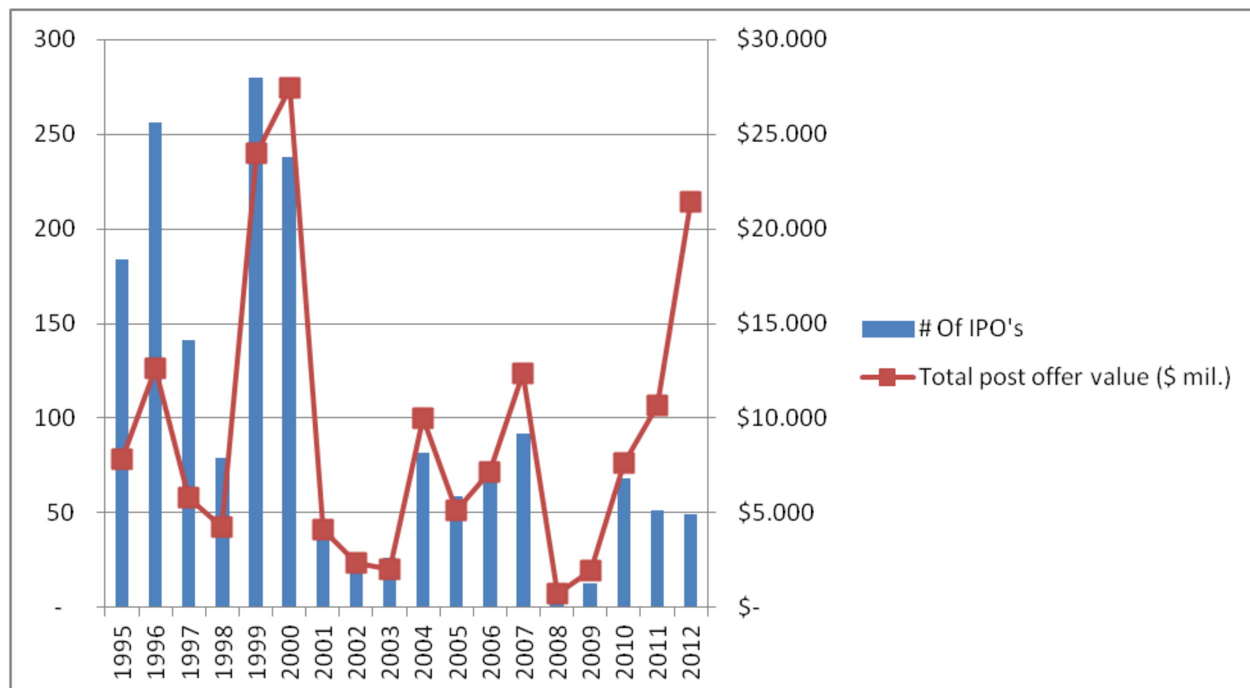
- Telecommunications
- Software
- Semiconductors
- Retailing/Distribution
- Other
- Networking and Equipment
- Medical Devices and Equipment
- Media and Entertainment
- IT Services
- Industrial/Energy
- Healthcare Services
- Financial Services
- Electronics/Instrumentation
- Consumer Products and Services
- Computers and Peripherals
- Business Products and Services
- Biotechnology

Annex 7: **VC backed IPOs, IPO offer amount ($) and VC backed IPO's as a percentage of total number of IPOs.**[99]

Year	# of IPOs	Offer amount ($ Mil.)	% Of total
1995	184	7859	N/A
1996	256	12666	N/A
1997	141	5831	N/A
1998	79	4221	N/A
1999	280	24005	N/A
2000	238	27443	69
2001	37	4130	46
2002	24	2333	32
2003	26	2024	39
2004	82	10032	44
2005	59	5113	35
2006	68	7127	41
2007	92	12365	57
2008	7	765	30
2009	13	1980	33
2010	68	7609	65
2011[100]	51	10690	51
2012	49	21451	37

[99] Data: Cambridge Associates: Pooled IRR based on fund initial stage. Vintage tear funds formed since 2009 are too young to have produced meaningful returns.
[100] Vintage years 2011 - 2012 total post offer value can be largely attributed to the IPOs of Facebook, Groupon, Linkedin, Workday and Zynga.

Annex 8: **VC backed IPOs and total post offer value.**



Annex 9: **VC firms and returns.** [101]

Year	# of Firms	Pooled return (%)
1995	35	88.46
1996	41	102.96
1997	71	91.80
1998	81	12.04
1999	114	-0.93
2000	154	0.23
2001	53	2.27
2002	34	-0.41
2003	39	6.51
2004	66	8.01
2005	61	4.57
2006	77	6.50
2007	62	11.81
2008	56	11.95
2009	20	18.87
2010	35	14.92

[101] Data: Cambridge Associates: Pooled IRR based on fund initial stage. Vintage tear funds formed since 2009 are too young to have produced meaningful returns.

<u>Annex 10:</u> Deals vs. Exits.