VENTURE CAPITAL FORMATION AND ACCESS: LINGERING IMPEDIMENTS OF THE INVESTMENT COMPANY ACT OF 1940

Duke K. Bristow*

Benjamin D. King**

Lee R. Petillon***

---

* Duke K. Bristow, Ph.D., is an economist with the Harold Price Center for Entrepreneurial Studies at the Anderson Graduate School of Management at UCLA. Please direct correspondence to Dr. Bristow at the UCLA Anderson School, 110 Westwood Plaza, Entrepreneurs Hall, Suite C305, Los Angeles, CA 90095. His e-mail is dbristow@anderson.ucla.edu.

** Benjamin D. King, J.D., M.B.A., is a legal and business consultant with PricewaterhouseCoopers LLP in their Financial Advisory Services group. A graduate of the UCLA School of Law and the Anderson School at UCLA, he also served on the UCLA Law Review.

*** Lee R. Petillon is a partner with Petillon & Hiraide LLP, a Torrance, California, based law firm, practicing corporate and securities law primarily with start-ups and early stage companies.

The authors thank Kim Schelble for excellent research assistance. Laura Bristow, Charles Gnecco, and Jennifer Ku are thanked for proofreading. Any errors are our own.

I. INTRODUCTION

Despite its acknowledged importance to the vitality of the American economy, venture capital remains governed by a patchwork regulatory structure. This regulatory labyrinth often proves onerous to capital formation and access to activities by entrepreneurs and investors, creating various artificial inefficiencies without advancing any justifiable legislative policy aim. The primary problem is that venture capital firms are not regulated based on their own unique identity, but rather are incidentally overseen by other securities and investment laws, the genesis of which derives from legislation in the 1930s and 1940s—a time far removed from the dynamic role venture capital has come to play in the modern American economy.

The literature reflects the dissonant nature of venture capital regulation. The contractual nature of venture capital transactions along with the recent role of law firms in venture financing has received some attention.[1] The discriminatory tax and shareholder implications of the regulatory framework overseeing venture capital activity also have been discussed.[2] Finally, the failure of the business development company ("BDC") program, one of many congressional attempts to enhance venture activity by publicizing it instead of deregulating it, has been examined.[3]

---

[1] *See* Peter Mikhail, Note, Hopkins v. Cellpro: *An Illustration That Patenting and Exclusive Licensing of Fundamental Science Is Not Always in the Public Interest*, 13 HARV. J.L. & TECH. 375 (2000); Alice W. Yao, Comment, *Former Corporate Officers and Employees in the Context of the Collective Entity and Act of Production Doctrines*, 68 U. CHI. L. REV. 1487 (2001); William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891 (2002).

[2] *See* Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1 (1988); Ronald J. Gilson & Reinier Kraakman, *Investment Companies As Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate*, 45 STAN. L. REV. 985 (1993).

[3] *See* Reginald L. Thomas & Paul F. Roye, *Regulation of Business Development Companies Under the Investment Company Act*, 55 S. CAL. L. REV. 895 (1982).

However, a complete analysis of the regulations the venture capitalist, entrepreneur, and average investor face in this area remains significantly absent from legal scholarship.

This paper endeavors to fill this void in understanding the importance of venture capital, how it is regulated, and what public policy concerns may by implicated. As the reader will see, the regulatory oversight of venture capital is highly complicated, multi-layered, often a result of legislative objectives completely divorced from the actual operations of venture capital firms, and, despite purported reforms, still highly incoherent in nature. The reader also will see that the achievement of a more sensible system, in which market efficiencies are allowed to operate and *all* investors are allowed to have a diversified portfolio inclusive of venture capital investments, raises the most fundamental policy issues of the American system where a free market economy is juxtaposed by safeguards to protect the integrity of the markets.

Through boom and bust, the vibrancy of American entrepreneurial activity, particularly its ability to commercialize all manner of innovation, supported by the most efficient markets in the world, has made the United States an economic powerhouse. There are many factors behind the post-World War II U.S. economic success story. One undeniable force propelling the astounding growth has been the relative abundance of risk capital available to new U.S.-based enterprises.[4] This venture capital provides fledgling enterprises with their life-blood, namely the cash that they need to grow. Because so many of these companies offer innovative products and services, venture capitalists perform a vital function for the economy and for society: allocating their funds through expert selection and

[4] That is not to say that the availability of venture capital is purely causal. Investment of risk capital is cyclical in nature and therefore may be as much a reflection as it is a cause of economic expansion. *See* CYNTHIA A. BELTZ, FINANCING ENTREPRENEURS 20-26 (1994). However, the abundance of venture capital and an entrepreneurial mindset unarguably are part of the United States' considerable economic advantage over other countries where they are all but entirely absent. *See id.* at 31-32, 45-46.

management in order to bring the most promising inventions to fruition.

The venture capitalist plays a critical role in mitigating the risks inherent to the pursuit of economic and technological advances. Without the selection, investment, and active management of venture capitalists, economic and technological progress would be much more difficult because there are limited sources of risk capital and an even more limited amount of managers experienced in overseeing the growth of new companies. Furthermore, small businesses, with less than 500 employees, now account for almost all of the new jobs created.[5] Thus, the capital that funds the birth and the expansion of emerging companies truly fuels the engine of economic growth.[6]

The United States leads the world in venture capital.[7] Since the recession of 1990-91, the amount of venture capital invested in start-ups has skyrocketed from roughly $1.2

---

[5] *See* OFFICE OF ECON. RESEARCH, U.S. SMALL BUS. ADMIN., THE NEW AMERICAN EVOLUTION: THE ROLE AND IMPACT OF SMALL FIRMS (1998); *see also* OFFICE OF ADVOCACY, U.S. SMALL BUS. ADMIN., SMALL BUSINESS ANSWER CARD 1998, *at* http://www.sba.gov/advo/stats/answer.pdf (last visited Dec. 2, 1999); Duke K. Bristow & Lee R. Petillon, *Public Venture Capital Funds: New Relief from the Investment Company Act of 1940*, 18 ANN. REV. BANKING L. 393, 431 n.219 (1999) (according to a communication between the authors and Gregory J. Dean, Jr., Assistant Chief Counsel for Banking and Finance in the Office of Advocacy for the Small Business Administration ("SBA"), between 1979 and 1993, Fortune 500 employment dropped from 16 million to 11.5 million jobs, while small businesses generated over 24 million new jobs).

[6] In 1994, roughly at the midpoint of the last economic expansion, small businesses accounted for 99.7% of the nation's employers, employed 50% of the private work force, contributed 52% of all sales in the United States, and were responsible for 50% of the private gross domestic product. *See Hearing on Small Business' Access to Capital: Impediments and Options Before the House Committee on Small Business*, 104th Cong. (1996) (statement of Rep. Jan Meyers, Chair of the Committee).

[7] Stifling regulations and alliances between the political elite and established firms inhibit start-ups abroad. *See* Beltz, *supra* note 4, at 31-32, 92. For instance, during the most recent downturn in venture capital, the number of new companies formed in the United States were still tenfold greater than the number in Japan. *See id.* at 32.

billion to the peak of $70 billion in 2000.[8] Even with the current slowdown, venture investments have totaled $36.5 billion for 2001, making it the third best year ever.[9] In addition, investors have started two hundred new venture funds in 2001 with $55 billion in commitments, also one of the best years ever.[10] These results confirm that "major limited partners remain committed to the long term nature of venture capital."[11] While the first Internet boom has come and gone, seasoned venture capitalists realize that their business is cyclical and that new attractive sectors will emerge.[12]

Despite the overall sharp increase in venture capital funding during the 1990s, some economists believe a significant gap remains between the number of companies seeking funds and the amount of venture capital either invested or available.[13] The theoretical economic issue of

[8] *See 200 Venture Funds Were Started This Year*, N.Y. TIMES, Dec. 28, 2001, at C6; *see also* Table 1, History of Venture Capital Commitments and Investments (1969-2001) *infra*.

[9] *See* PRICEWATERHOUSECOOPERS ET AL., FULL YEAR & Q4 2001 RESULTS, MONEYTREE SURVEY, *at* http://www.pwcmoneytree.com /PDFS/MT_Q4_01_ Report.pdf; *see also* Table 1 *infra*.

[10] *200 Venture Funds*, *supra* note 8, at C6; *see also* Table 2, Growth of Venture Capital Funds (1980-2001) *infra*.

[11] *200 Venture Funds*, *supra* note 8, at C6 (quoting Ken Andersen, editor of VentureWire).

[12] From 1976 to 1986, conventional venture investing underwent an explosive increase similar to that of the late 1990s. Like the Internet and related sectors, the hard "Winchester" disk drive industry received the attention of investors, believing it to be a nirvana. While the technology proved revolutionary, its commercial profitability did not, and the product became a commodity with low profit margins. Despite the recent dot-com fallout, the most recent data reveals that "traditional venture firms are diversifying their investment strategies," with particular interest in the life sciences, and continuing to raise significant capital. *See* Press Release, VentureWire, Year 2001 Report on New Venture Funds (Dec. 27, 2001), *at* http://www.venturewire.com.

[13] There are some economists who debate the significance of any "capital gap" that may exist. *See* BELTZ, *supra* note 4, at 43. However, these economists believe in the proper allocation of capital through market efficiency and are opposed to government intervention, more than they

precisely how much venture capital is optimal lies beyond the scope of this paper. Rather, the focus here is upon the pervasive belief among legislators, economists, and business people that the regulatory system, developed during and immediately after the Great Depression, overseeing venture capital activity should be modernized. This paper evaluates the efforts to do so and attempts to navigate the labyrinth of patchwork regulation overseeing the activities of venture capitalists.

The nexus of capital access and formation inefficiency lies in the federal securities legislation that regulates venture capital funds, specifically the Investment Company Act of 1940 ("'40 Act").[14] As will be discussed later, the main problem with the '40 Act is that it was designed with 1930s technology in mind to regulate the financial institutions of that time and to mitigate problems generally unrelated to modern capital access firms and the firms in which they invest. In the sixty-plus years since the '40 Act, the government has attempted to improve capital formation and access. These patchwork attempts, however, often have lacked cohesion, have produced mixed results at best, and have neglected to address inapt logic and policy concerns at the core of the regulatory structure. In 1996, Congress enacted bipartisan landmark legislation, the National Securities Markets Improvement Act ("NSMIA"),[15] to overhaul the shortcomings of the federal regulatory scheme for an array of financial and investment institutions,

believe in the absence of inefficiencies in the venture capital market. *See id.* at 61-86, 91-92. In other words, skeptics of a capital access problem premise their positions on the belief that capital will inevitably follow value creation and productivity, and therefore, any short-term gaps are temporary. *See id.* at 62-63, 87, 91-94.

[14] The Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (2000).

[15] *See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C. (2000)).

including venture capital funds.[16] While the intent and the extent of the overhaul was impressive, its results are less so.

The relevant provisions of the NSMIA created a new exemption to the '40 Act, contingent upon subsequent enabling state legislation that invited more state government oversight. California, the national leader in venture capital, became the first state to enact the requisite state legislation as a follow-up in 1998.[17] Concurrent federal and state legislation also addressed venture capital vehicles other than the traditional partnership form, such as state-sponsored funds, institutional funds, federal venture funds, and publicly traded incubators. This paper will examine the net effects of the latest reformations, the lingering impacts of the '40 Act, and evaluate the need for continued regulatory relief and rationality. As will be discussed, the issue is punctuated by important political, economic, and public policy concerns such as the role of federal and state government, the protection of investors, expanding access to better investment returns, and enhancing the trajectory of sustainable economic growth.

Following this introduction, Part II will briefly discuss the history of ineffectual reform prior to the NSMIA. The reasons underlying these failures help illustrate the proper direction for future regulation. Part III details the current state of regulation for venture capital, in light of the NSMIA and the California Capital Access Company Law ("CACL"). Part IV examines the net effects of these laws and other recent capital formation legislation—an important investigation because as venture markets gain efficiency in one area, they often become burdened by regulations in other

---

[16] President Clinton signed the NSMIA into law on October 11, 1996, declaring it "the most significant overhaul of the securities regulatory structure in decades [that] [w]ithout compromising investor protection . . . will enhance capital formation and the competitiveness of the American economy." Statement on Signing the National Securities Markets Improvements Act of 1996, 32 WEEKLY COMP. PRES. DOC. 2038 (Oct. 11, 1996).

[17] *See* Capital Access Company Law, CAL. CORP. CODE §§ 28000-28958 (West Supp. 2004).

areas. Part V concludes with a policy analysis and presents suggestions for future efforts at comprehensive, coherent regulatory relief.

II. THE EVOLUTION OF VENTURE CAPITAL AND ITS REGULATION

A. The Investment Company Act of 1940 ("'40 Act")[18]

The impetus for the '40 Act was the real and imagined abuses that occurred in the operation of investment companies prior to and during the Depression.[19] Congress sought to protect investors by regulating such companies, which constituted public investment tools for those who lacked enough assets to justify their own financial advisor.[20] The specific objectives of the '40 Act were to curtail unfair sales brokerage practices and charges, establish reasonable advisory fees, ensure honest, objective management, generate greater management participation by shareholders, promote solid capital structures, and institute guidelines for financial reporting and accounting.[21]

The '40 Act defines an "investment company" as any company that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities."[22] This

---

[18] The Investment Company Act of 1940, 15 U.S.C. § 80a-1 to -64 (2000).

[19] Abuses ranged from poor management and over-leverage to pyramid schemes and fraudulent misappropriation of funds. These abuses prompted a four-year study by Congress, the conclusions of which led to the '40 Act. *See generally* Bristow & Petillon, *supra* note 5, at 395-96 (describing the historical background of the '40 Act).

[20] *See id.* at 395.

[21] *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 40-45 (1995), *noted in* Bristow & Petillon, *supra* note 5.

[22] 15 U.S.C. § 80a-3(a)(1)(A) (2000). The term "security" includes any "right to subscribe to or purchase" securities. 15 U.S.C. § 80a-2(a)(36). The full text of 15 U.S.C. § 80a-3 defines an "investment company" as any issuer that: (1) "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or

definition arguably does not include venture capital firms, unlike mutual funds. Venture capital firms indirectly and directly engage in the businesses of the portfolio companies that they control. The initial investment usually marks the beginning of a seven to ten year relationship in which the venture capitalist helps the entrepreneur build a strong management team, manage rapid growth, and develop strategic partnerships. Venture capitalists themselves often assume management positions until others can be recruited. Therefore, venture funds might not "primarily engage" in investing in securities, particularly when contrasted with mutual funds, the regulatory target of the '40 Act.

The typical venture capital investment time horizon is seven to ten years, during which the firm actively recruits executives, provides management oversight, and fosters partnerships, while a mutual fund may modify its investment positions on up to a quarterly basis and has no similarly meaningful role in managing the operations of the companies in which it invests. However, the SEC rejected this argument, maintaining that a company that acquires the securities of controlled companies with the intent of reselling them rather than operating the companies' businesses for the long term qualifies as an investment company.[23] The federal courts still have not developed a precise definition of "long-term," and so the distinction remains ambiguous and artificial. As a result, venture capital funds generally have fallen under the purview of the

---

trading in securities"; (2) "is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding"; or (3) "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis."

[23] *See* SEC v. Fifth Ave. Coach Lines, Inc. 289 F. Supp. 3 (S.D.N.Y. 1968), *aff'd by* 435 F.2d 510 (2nd Cir. 1970) (specifying when a company is 'primarily engaged' in investing in securities), *noted in* Douglas G. Smith, *The Venture Capital Company: A Contractarian Rebuttal to the Political Theory of American Corporate Finance?*, 65 TENN. L. REV. 79, 139 (1997).

'40 Act, which imposes exceedingly onerous regulations intended for mutual funds.[24]

The '40 Act, however, contains an important exception. A company with outstanding securities beneficially owned by not more than one hundred persons that does not make a public offering of its securities can escape regulation under the '40 Act.[25] Thus, *private* venture capital companies use this exemption to avoid the '40 Act registration by forming limited partnerships with less than one hundred investors. The venture capital industry, then, has been characterized by funds highly restricted in the number of investors.

---

[24] Major problems for venture capital funds under the '40 Act exist. First, prohibitions on the issuance of warrants, options, or securities in exchange for services rendered to the company constrain labor contracts. Second, restrictions on the sale of the company's common stock at less than net asset value impede a registered venture capital fund that seeks to make a secondary offering of its securities in order to raise capital. Because venture capital firms generally are closed-end, their shares often trade at less than net asset value. In other words, because they are not publicly traded, venture funds do not achieve valuations above (nor often equal) to their book value. Third, the proscription of joint enterprises or arrangements between the investment company and affiliated persons, promoters, or principal underwriter of or for the company could forbid co-investment by the fund and the manager or persons related to the manager. Fourth, it could also forbid tandem investments between funds managed by the same or related advisers. The custody requirements in § 17(f) are unnecessary given the illiquid nature of venture capital companies' portfolio securities holdings. Fifth, the § 18(c) ban on issuing multiple classes of senior securities constrains the ability of venture capital funds to raise capital. *See* WILLIAM J. HEWITT ET AL., FORMATION OF VENTURE CAPITAL FUNDS: NON-TAX LEGAL CONSIDERATIONS 143-45 (1991) (noting why venture capitalists consider regulation under the '40 Act so onerous).

[25] 15 U.S.C. § 80a-3(c)(1) (2000). In addition, an exemption exists for a company whose securities have been sold intrastate only to residents of a state under the laws of which such company is organized or created and whose total offering does not exceed $10 million. *See id.* at § 80a-6(d). This amount was increased from $100,000 to $10 million by the NSMIA. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 502, 110 Stat. 3416, 3445 (codified at 15 U.S.C. § 80a-6(d)(1) (2000)). However, this exception generally is not used because the minimum amount of money required to operate a venture capital fund is larger still, perhaps closer to $100 million.

Because of the legal complexity involved in determining beneficial ownership interests under § 3(c)(1),[26] venture firms have had to err on the side of caution in order to maintain their exemption, resulting in partnerships of far less than one hundred people.[27] Thus, sophisticated investors, both individual and institutional, who neither need nor desire the protections of the '40 Act have been unduly restricted by having to maintain their unregistered status by adhering to the one hundred investor limit.[28] This restriction serves only to promote the access of those investors with the deepest pockets to venture investing.[29] The average fund size presently is $93.8 million.[30] Assuming equal contributions of one hundred partners, the average limited partner needs to contribute roughly $1 million for her part, requiring liquid wealth greater than the accredited investor requirements of $200,000 per annum income or $1 million net worth. This situation exists *before* the application of any "look-through" provisions, which could reduce the number of investors significantly below a hundred.

---

[26] *See* The Task Force on Hedge Funds, *Report on Section 3(c)(1) of the Investment Company Act of 1940 and Proposals to Create an Exception for Qualified Purchasers*, 51 BUS. LAW. 773 (1996); *see also* Smith, *supra* note 23, at 142-43 (noting one reason for caution is that the Securities Exchange Commission ("SEC") has implemented a "look through" provision, which counts not only the number of limited partners but also partners or shareholders if any of the limited partners are entities such as partnerships or corporations).

[27] Most funds operate with only ten to thirty limited partners. *See generally* Nat'l Venture Capital Ass'n, NVCA Members, *at* http://www.nvca.com/ members.html (last visited Feb. 27, 2004).

[28] As will be discussed later, this finding by the Task Force on Hedge Funds, a committee organized by the American Bar Association Committee on Federal Regulation of Securities, helped prompt Congress to draft the NSMIA in 1996, which created new exemptions in the '40 Act. *See* The Task Force on Hedge Funds, *supra* note 26.

[29] *See* Table 3, Distribution of Wealth Among U.S. Households *infra* (illustrating how few households meet the "net worth" accreditation requirement of $200,000 income per annum prescribed by § 2(a)(15) of the Securities Act of 1933).

[30] As of 2002, the average venture fund size is $93.4 million. *See* Nat'l Venture Capital Ass'n, NVCA FAQs Page, *at* http://www.nvca.com.

B. The Small Business Investment Act of 1958 ("SBIA")[31]

The venture capital industry as we know it really dates back only twenty-five years or so.[32] The first two progenitors of venture capital firms began operations in 1946.[33] Because venture capital was in such a nascent stage of development and the United States was embroiled in World War II, the rebuilding of Europe, the Korean War, and the beginning of the Cold War, the inhibiting effects of the '40 Act on enterprising businesses accessing capital went largely unrecognized. However, in the late 1950s, Congress began to take notice.[34]

Instead of amending the '40 Act, Congress passed the SBIA in 1958, which created small business investment companies ("SBICs"). SBICs are venture investment companies licensed and regulated by the Small Business Administration ("SBA"). The particulars of their regulation are beyond scope of this paper. What is important is that the

---

[31] 15 U.S.C. §§ 661-697g (2000).

[32] *See* George W. Fenn et al., *The Private Equity Industry: An Overview*, FIN. MARKETS, INSTITUTIONS, AND INSTRUMENTS, Nov. 1997, at 10-13. *But see* PRATT'S GUIDE TO VENTURE CAPITAL SOURCES 8-9 (Stanley E. Pratt & Jane K. Morris eds., 11th ed. 1987) (dating venture capital back to ancient investments seeking high returns, including Queen Isabella's sponsorship of Christopher Columbus' voyage to the New World).

[33] John H. Whitney organized a venture partnership with $10 million dollars (approximately $80 million in today's dollars based on inflation as estimated by the Consumer Price Index). General Georges F. Doriot and several others founded the American Research and Development Corporation (AR&D) the same year. The Phipps and Rockefeller families eventually followed suit with pioneering firms that would become Bessemer Securities and Venrock, respectively. For good background on the early history of venture capital, see JOSEPH W. BARTLETT, VENTURE CAPITAL: LAW, BUSINESS STRATEGIES, AND INVESTMENT PLANNING (1988) and Fenn et al., *supra* note 32.

[34] The Soviet launch of Sputnik on October 4, 1957, which generated fears that the United States was losing its technological superiority, as well as a report by the Federal Reserve Board that same year regarding the lack of access to equity capital, both played an instrumental role in generating the SBIA. *See* Fenn et al., *supra* note 32, at 11.

serious flaws of the SBIA and the SBIC program gave rise to the modern era of venture capital activity.[35] By 1978, capital committed to private, unsubsidized venture capital funds exceeded federally sanctioned SBICs by almost threefold, despite the fact that SBICs received 50-75% of their capital from the government.[36] More importantly, traditional venture capital funds still operated in the illogical and poorly designed regulatory structure of the '40 Act, which Congress, in its attempt to promote capital formation, ignored, instead creating an unsound program that despite its subsidies essentially failed.

C. The Small Business Investment Incentive Act of 1980 ("SBIIA")[37]

In response to the rise of venture capital funds and those funds competing with the government's SBICs, Congress attempted to provide exemptions to the '40 Act with the passage of the SBIIA in 1980. However, like the SBIA, the legislation essentially created a new kind of venture investment company instead of adopting regulations better suited to traditional venture capital firms. The SBIIA defined a new kind of company called a "business

[35] The SBIC program contained crucial flaws. First, SBICs were required to pay interest on leverage obtained from SBA loans. As a result, they concentrated on debt, not equity, financing. *See* Fenn et al., *supra* note 32, at 12. The long pay out structure that most traditional venture funds have (usually seven to ten years) does not suit leveraged investors. Thus, many SBICs failed because of their debt burden, which left them unable to survive until capital returned from the companies in which they invested. *See* Bristow & Petillon, *supra* note 5 at 411, 419. Second, SBICs often did not attract high quality managers. As a result, SBICs became an unintended hotbed of mismanagement and corruption. *See* Fenn et al., *supra* note 32, at 12; Bristow & Petillon, *supra* note 5, at 411. Finally, SBICs were restricted from taking controlling interests in and from investing in portfolio companies of a certain size.

[36] *See* Bristow & Petillon, *supra* note 5, at 440 tbl.5.

[37] Pub. L. No. 96-477, 94 Stat. 2275 (codified in scattered sections of 15 U.S.C. (2000)).

development company" ("BDC").[38] While exempting BDCs from §§ 1-53 of the '40 Act, the SBIIA subjected them to regulations under newly created §§ 55-65.[39] As stated in Bristow and Petillon, "what Congress gave in the 1980 Act, in exempting BDCs in its left hand, Congress took back in its right hand" by imposing additional regulations.[40] As a result, the SBIIA failed to generate a substantial increase in small business investment through BDCs.[41]

[38] BDCs are closed-end companies with at least 70% of their assets invested in "eligible portfolio companies" and must provide significant managerial assistance to the issuers of their securities. *See* 15 U.S.C. § 80a-2(a)(48) (2000).

[39] Thus, the company is still subject to a variety of regulations governing its conduct. Such regulations control: "follow-on" investments in securities of issuers that were formerly eligible portfolio companies; investments in securities acquired in bankruptcy or work-out situations; investments in portfolio companies through private placements in which the BDC owns at least 60% of the outstanding equity securities immediately prior to the additional investment; investments in securities received in certain exchanges for qualifying investments; and investments in cash and high-quality debt investments. *See* 15 U.S.C. § 80a-54 (2000). Furthermore, BDCs must have a majority of disinterested directors; are prohibited from engaging in certain transactions with affiliated persons without prior approval from either the SEC or from the disinterested directors or general partners of the venture capital company who have no financial interest in the transaction; are subject to regulation of options and rights acquisitions of directors, officers, employees, and general partners; are subject to regulation of their issuance of debt securities; must maintain a minimum asset coverage ratio; and are subject to regulation of their employee stock and option plans. *See* 15 U.S.C. §§ 80a-54 to -62 (2000). For a particularly helpful illustration of BDC regulations, see Bristow & Petillon, *supra* note 5, at 435 tbl.1.

[40] *See* Bristow & Petillon, *supra* note 5, at 399.

[41] In 1993, there were only about forty-four active BDCs with assets of about $2.5 billion. *See* S. CONF. REP. NO. 104-293, at 27 (1996). In 1995, the number of active BDCs increased to sixty, but the assets under management declined to $2.1 billion. *See id.*

III. THE CURRENT STATE OF VENTURE CAPITAL REGULATION

A. The National Securities Markets Improvement Act of 1996 ("NSMIA")[42]

1. Background and Description of the Act

In 1996, Congress provided significant potential relief from the '40 Act. The seemingly insatiable demand[43] for early stage risk capital prompted the passage of the NSMIA, which added a new section, § 6(a)(5), to the '40 Act. This section exempts investment funds that provide financial or managerial assistance to businesses from regulation under the '40 Act. The conditions for such an exemption are the following:

> 1. The company is not engaged in the business of issuing redeemable securities.[44]
>
> 2. The operations of the company are subject to regulation by the state in which the company is organized.[45]
>
> 3. The state regulatory statute governs entities that provide financial or managerial assistance to

---

[42] Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C. (2000)).

[43] One reason that demand for risk capital may appear insatiable is such capital promotes innovation with each investment. At its core, each venture investment embodies the desire to make life better for some segment of customers, through either increasing productivity or expanding consumer choices and freedoms. The precise relationship between the amount of capital invested in innovation and the amount of improvement in consumer happiness may be difficult to measure empirically. However, the demand for such innovation among consumers certainly is tremendous, and the amount of capital invested toward innovation may well be fractional compared with these consumption desires.

[44] 15 U.S.C. § 80a-6(a)(5)(A) (2000).

[45] *Id.*

> enterprises doing business, or proposing to do so, in the state.[46]
>
> 4. The organizational documents of the company state that its activities are limited to the promotion of economic, business, or industrial development in the state or to the provision of financial or managerial assistance to enterprises doing business, or proposing to do so, in the state.[47]
>
> 5. At least 80% of the securities of the company must be offered and sold to residents of the state or persons having a substantial business presence in the state.[48]
>
> 6. All of the investors must be accredited investors as defined in § 2(a)(15) of the Securities Act of 1933.[49]
>
> 7. The company does not purchase securities issued by an investment company registered under the '40 Act.[50]
>
> 8. The company files a notification with the SEC that it intends to rely on the exemption provided in § 6(a)(5).[51]
>
> 9. The exemption is subject to any additional terms or conditions that the SEC may adopt by rule, regulation, or order.[52]

The bill garnered bipartisan support as a "prudent means by which Congress can help sustain and or even increase the

---

[46] *Id.*
[47] *Id.* § 80a-6(a)(5)(A)(i).
[48] *Id.* § 80a-6(a)(5)(A)(ii).
[49] *Id.* § 80a-6(a)(5)(A)(iii).
[50] *Id.* § 80a-6(a)(5)(A)(iv).
[51] *Id.* § 80a-6(a)(5)(C).
[52] *Id.* § 80a-6(a)(5)(E).

Nation's rate of economic growth"[53] and a vehicle to "help venture capitalists tap the capital markets to fund business endeavors."[54] The impetus shifted to the state legislatures to determine what regulatory oversight may be warranted.

2. Analysis of the NSMIA

The four major capital formation reforms enacted in the NSMIA contain key limitations and therefore have not produced the intended results (for an explanatory chart of the four reforms, see Table 4 *infra*). There are three exemptions, two of which are largely ineffectual. The third exemption is the § 6(a)(5) amendment to the '40 Act, which has the most promise. In addition, the NSMIA attempted to liberalize regulation of BDCs, which has not produced favorable results. The following analysis confirms that the § 6(a)(5) exemption, coupled with state enabling acts such as California's Capital Access Company Law ("CACL"), potentially offers the only measure of regulatory relief to venture capital formation in the NSMIA.

(i) The Intrastate Exemption

The NSMIA increased the size of the intrastate exemption from an aggregate amount of $100,000 to $10 million.[55] In addition, any securities offering still must be completely intrastate.[56] However, the bare minimum threshold for operating a venture capital fund is around $10 million and most require closer to $100 million to remain viable long-term.[57] As a result, most venture capital funds

---

[53] 142 CONG. REC. S12,094 (1996) (statement of Sen. Christopher Dodd).

[54] 142 CONG. REC. S12,093 (1996) (statement of Sen. Alfonse D'Amato).

[55] National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 502, 110 Stat. 3416, 3445 (codified at 15 U.S.C. § 80a-6(d)(1) (2000)).

[56] *See* 15 U.S.C. § 80a-6(d)(2) (2000).

[57] *See* Bristow & Petillon, *supra* note 5, at 402 n.61. Based on a typical annual management fee of 2.5% of assets, a $10 million fund would

cannot use this exemption.[58] Those funds that attempt to do so must remain exceedingly small in size, enduring the inefficiencies that entails, and local with their purchasers.[59]

(ii) Qualified Purchasers

The NSMIA also creates an exemption for investment companies whose securities are owned by "qualified purchasers" and are not publicly offered.[60] However, the legislation defines "qualified purchasers" as natural persons who own at least $5 million in investments or institutions that own at least $25 million in investments.[61] Unlike § 6(a)(5), the exemption does not require state regulation. However, the high threshold limits its efficacy since individuals and institutions that wealthy can instead use the less than one hundred owner exemption provided by § 3(c)(1) of the '40 Act because the accredited investor threshold is lower than the qualified purchaser criteria.

(iii) Added Flexibility for BDCs

The NSMIA also liberalizes the regulation of BDCs. The legislation creates a new class of portfolio companies in which BDCs can invest without making available significant managerial assistance. This new class includes any company that has total assets of $4 million or less and capital and surplus (equity less retained earnings) of more than $2 million.[62] The NSMIA also allows BDCs to issue debt and purchase securities more freely.[63] However, Congress' belief "that changing BDC regulation . . . will make this type of

---

generate fees of $250,000. That amount would have to cover salaries, rent, and all other expenses. *See id.*

[58] *See* Kimberly Weisul, *Loophole Emerges for Small Venture Funds, Investors*, INVESTMENT DEALERS DIG., May 12, 1997, at 5 (quoting attorney William Evers that the exception is "just barely high enough to be useful").

[59] *See id.*

[60] 15 U.S.C. § 80a-3(c)(7) (2000).

[61] 15 U.S.C. § 80a-2(a)(51)(A).

[62] 15 U.S.C. § 80a-2(a).

[63] *See id.*

investment vehicle more attractive" remains juxtaposed by the continued decline of BDCs.[64] Moreover, many of the restrictions in the SBIIA still remain intact.[65]

B. The California Capital Access Company Law

1. Background and Significance of the Act

To date, no state other than California has enacted enabling statutes that take advantage of the exemptions provided by the NSMIA. It is not surprising that California has taken the lead in passing such legislation. Small businesses and start-up companies, which have generated over one million new jobs, piloted the economic recovery in California during the 1990s.[66] Furthermore, California leads the country in venture capital investments ($13.3 billion), venture-backed company jobs (1.4 million) and revenues ($270 billion).[67] As a result, the legislature concludes that "promoting the establishment, growth, and expansion of business firms in this state is an efficient way to increase job opportunities."[68] Curiously, other states with significant

---

[64] S. CONF. REP. NO. 104-293, at 13 (1996).

[65] *See* Pub. L. No. 96-477, 94 Stat. 2275 (codified in scattered sections of 15 U.S.C. (2000)).

[66] *Capital Access Company Law: Hearing on SB2189 Before Assembly Committee on Appropriations,* 1998 Leg. (Cal. 1998) (bill information), *available at* http://www.leginfo.ca.gov/pub/97-98/bill/sen/sb_2151-2200/sb_2189_cfa_19980803_155911_asm_comm.html (last visited Dec. 3, 1999).

[67] John Taylor, Venture Capital Industry Update, Presentation at Southwest Venture Capital Forum (Jan. 10, 2002), *at* http://swvf.org/clients/smu/registration.nsf/415bcff8e8e0d7c486256991005f9beb/$FILE/NVCA%20JSTSWVF.ppt (discussing the 2001 DRI-WEFA study results); *see also* Table 5, Venture Capital Analysis for Top Ten States for 2001 *infra.*

[68] *Capital Access Company Law: Hearing on SB2189 Before Assembly Committee on Banking and Finance,* 1998 Leg. (Cal. 1998) (bill information), *available at* http://www.leginfo.ca.gov/pub/97-98/bill/sen/sb_2151-2200/sb_2189_cfa_19980626_152826_asm_comm.html (last visited Dec. 5, 1999).

venture capital activity, such as Massachusetts, Washington, Texas, Colorado, and New York, do not yet even have proposed legislation, despite a recent study that reveals venture-backed companies now employ over 7.6 million people and generate $1.3 trillion in annual revenue.[69] These employment and revenue figures represent 5.9% of the U.S. payroll, 13.1% of the GDP, and 7.9% of U.S. company revenue.[70]

The CACL, then, constitutes a particularly important piece of legislation, since it likely will serve as a model for the rest of the country. The Act presents a negotiated compromise between its proponents and the Department of Corporations, which advocated a more restrictive regulatory approach.[71] Signed into law on September 20, 1998, the CACL received broad bipartisan support and easily passed through the legislature.[72] Because it represents a piece of

---

[69] While California has the greatest amount of venture capital activity, the growth of regional investment hubs, the continued demand across the country for risk capital, and the increasing number of qualified investors necessitate enabling statutes. *See* Taylor, *supra* note 67 (discussing results of DRI-WEFA study conducted in 2000 on the economic effects of venture capital).

[70] *Id.*

[71] Two non-profit groups, the Capital Formation and Business Investment Committee ("CFBIC") and California Capital Access Forum ("CCAF"), played an integral role in introducing and adopting the bill. The CFBIC consists of a broad cross-section of venture capitalists, academics, policy makers, investment bankers, attorneys, and small business executives. The CCAF was founded in 1995 and sponsored three conferences on capital formation in 1995, 1996, and 1997 with the objective of promoting dialogue between government officials and small businesspersons. *See* Bristow & Petillon, *supra* note 5, at 426.

[72] Senator John Vasconcellos, a liberal Democrat from Silicon Valley, and Assemblyman Steve Kuykendall, a conservative Republican from the Los Angeles area, co-sponsored the bill. Lee Petillon, an expert in securities and corporate law and a partner with Petillon & Hansen, a law firm based in Torrance, drafted the original bill. The Department of Corporations proposed substantial amendments, notably requiring concomitant regulation of venture fund managers under the Investment Advisers Act of 1940 or the California Corporate Securities Law of 1968. After the ensuing negotiations and compromises, the Department withdrew its opposition.

compromise legislation between advocates of regulatory relief and investor protection, the CACL may be even more important for other states to examine, should they seek to improve capital formation through § 6(a)(5) of the '40 Act.

2. Description of the Act

The CACL provides for the licensure and regulation by the Commissioner of Corporations of capital access companies and allows them to provide risk capital and management assistance to small businesses in the state, exempt from the requirements of the '40 Act. In addition to establishing licensing fees,[73] civil and criminal penalties for violations,[74] and exempting the offer and sale of licensee securities from qualification under the California Corporate Securities Law,[75] the Act creates the following requirements for registration:

> 1. The applicant must have a tangible net worth of at least $250,000.[76]
>
> 2. The applicant must have funds of at least $5 million available for investment.[77]
>
> 3. The applicant must have financial resources ample to cover expenses for three years.[78]
>
> 4. The directors, officers, and controlling persons of the applicant must be "of good character and sound financial standing, competent to perform their functions and collectively adequate to manage the business of the applicant as a capital access company."[79] The Commissioner can take into account

[73] Capital Access Company Law, CAL. CORP. CODE § 28110 (West Supp. 2004).

[74] *Id.* §§ 28880, 28900-28901.

[75] *Id.* § 25102(p).

[76] *Id.* § 28152(a).

[77] *Id.* § 28152(b).

[78] *Id.* § 28152(c).

[79] *Id.* § 28152(d).

"the prior or current successful track record of the applicant's proposed management."[80]

5. Any person who makes investment recommendations must be registered as an investment advisor under the federal Investor Advisor Act of 1940 or California Corporate Securities Law of 1968.[81] Such a person cannot have been convicted of a felony or misdemeanor arising out of securities transactions or otherwise involved in fraudulent transactions.[82]

6. The applicant will comply with § 6(a)(5) of the '40 Act and the applicable provisions of the California Corporate Securities Law of 1968.[83]

The Act also includes relevant provisions of the § 6(5)(a) exemption such as the organizational document statement requirement, the 80% resident requirement for the sale of securities, the accredited investor securities sale restriction, the proscription of issuing redeemable securities, and the prohibition against purchasing securities offered by a '40 Act registered company.

3. Analysis of the Act

Overall, the CACL attempts to provide an appreciable amount of regulatory relief while maintaining adequate safeguards for investors.[84]

---

[80] *Id.*

[81] *Id.* § 28152(e).

[82] *Id.*

[83] *Id.* § 28151.

[84] In addition, the CACL created a fiscally sound regulatory structure to oversee the registration process. *Capital Access Company Law: Hearing on SB2189 Before Assembly Committee on Appropriations,* 1998 Leg. (Cal. 1998) (fiscal summary), *available at* http://www.leginfo.ca.gov/pub/97-98/bill/sen/sb_2151-2200/sb_2189_cfa_19980512_124341_sen_comm.html (last visited Dec. 3, 1999) (noting that application fees will offset all costs); *see also Capital Access Company Law: Hearing on SB2189 Before*

(i) Regulatory Relief

The most important feature of the Act is that licensees no longer need to limit themselves to under one hundred shareholders. Under the '40 Act, venture capital funds often excluded accredited investors in order to retain their exempted status. However, funds now will not be as restricted in the number of investors, allowing for a greater commitment of capital. As a practical matter, funds still will be limited to five hundred qualified purchasers, which is the threshold for regulation as a public entity under the Securities Act of 1934. Nevertheless, more qualified investors who previously lacked the desire or the means to establish their own fund now can participate in capital access companies. As many as half a million accredited investors with assets available for investment totaling $582 billion in California alone may be interested in committing capital to public[85] venture funds.[86] The effect is twofold. First, more capital will become available to emerging enterprises. Second, a greater number of people can enjoy the high, realized returns of venture capital funds.[87]

Assembly Committee on Appropriations, 1998 Leg. (Cal. 1998) (bill information), *available at* http://www.leginfo.ca.gov/pub/97-98/bill/sen/sb_2151-2200/sb_2189_cfa_19980803_155911_asm_comm.html (last visited Dec. 3, 1999).

[85] "Public" here refers to a fund owned by many shareholders—not necessarily a fund that has shares traded in the public markets.

[86] Philip Crawford, *California Is New Frontier for Private Bankers,* INT'L HERALD TRIB., Oct. 31, 1994, at 16. The article cites a survey of affluent California families which found 304,000 families with assets of $1-2 million, 94,000 families with assets of $2-5 million, and 18,000 families with $5 million or more for a total of 406,000 families with $582 billion in assets available for investment.

[87] *See* Michael Selz, *Venture Capital Investors Set a Record Last Year with $11.4 Billion in Funding,* WALL ST. J., Feb. 2, 1998, at B2. Venture capital returns in fact have exceeded those of the S&P 500 since the mid-1970s, even when viewed over a longer time horizon. From 1968 to 1983, the compounded annual rate of return for the S&P 500 was 7.9% compared to reports of 20% for venture capital funds. *See* JOHN W. WILSON, THE NEW VENTURES, INSIDE THE HIGH-STAKES WORLD OF VENTURE CAPITAL (1985). This time period was *before* the beginning of the great bull market.

The results are critical to the formation of capital. While they have become more prevalent, institutional venture funds offer less than 20% of their capital to early stage companies.[88] Only about 1% of the companies that submit their business plans to these funds receive funding.[89] Of the estimated 19,000 regulated investment companies, which hold roughly $5.4 trillion in assets, only 63 are BDCs.[90] Of the $2.4 billion in assets that they hold, BDCs only invest a fraction in emerging enterprises.[91] This paltry amount reflects the burdensome regulations that the '40 Act imposes and the SBIIA failed to mitigate. Thus, the passage of the NSMIA, and subsequently the CACL, finally promise a significant commitment of capital to venture capital funds that seek to assist the fledgling businesses that nourish the economy.

Enabling statutes similar to the CACL will become, if they are not already, critical to the developing "venture capitals" that are forming across the country.[92] In the first quarter of 2002, over half of the total venture capital

---

As of 1999, the one-, three-, five-, and ten-year return rates for early stage venture capital were 91.2%, 47.9%, 46.6%, and 24.5% respectively. *See* David G. Taylor, Presentation on Venture Capital State of the World at the Galef Symposium on Corporate Governance and Equity Offerings (February 23, 2000) (figures in his presentation are from Venture Economics and the National Venture Capital Association—some of which are available in press releases at http://www.ventureeconomics.com); *see also* Mitchell Pacelle, *LBO Investing for the Merely Rich—'Funds of Funds' Make it Easier for Wealthy Individuals to Invest in Buyout, Venture-Capital Sector*, WALL ST. J., Aug. 21, 1998, at C1 (estimating the five- and ten-year average returns at 35.1% and 21.7% per annum respectively versus 22.4% and 18.9% for the S&P 500).

[88] PRICEWATERHOUSECOOPERS ET AL., *supra* note 9.

[89] *See* FITZROY DEARBORN INTERNATIONAL DIRECTORY OF VENTURE CAPITAL FUNDS 2 (W. Keith Schilit & John T. Willig eds., 1996).

[90] *Id.*

[91] *Id.*

[92] *See generally* Scott Herhold, *Venture Capitals Funding Blossoms Beyond Silicon Valley as Regional Mini-hubs Take Root in the West*, SAN JOSE MERCURY NEWS, Nov. 14, 1999, at 1D (discussing the explosion of regional venture capital centers).

invested was outside of California.[93] James D. Atwell, Managing Partner of the Venture Capital Practice in the Global Technology Industry Group noted that "there aren't just pockets of technology [and venture activity] anymore; there's a proliferation."[94] The continued strength of this 'proliferation', however, will in part depend upon regulatory relief. Funds will be unable to participate in the NSMIA exemption unless the states where they operate pass enabling acts. Until then, the restrictions of the '40 Act will continue to constitute a rate-limiting factor on venture development and entrepreneurial growth.

(ii) Investor Protection

The CACL provides investors with an array of protections. First, requiring an applicant to have a $250,000 tangible net worth, $5 million of assets available to invest, and enough capital to operate a fund for three years are more than sufficient measures to ensure the solvency of a licensed fund. Second, the "good character" criterion for directors, officers, and controlling persons affords the state discretion when reviewing applications, allowing the assessment of the applicant's past management activity and general competency. Third, obligating applicants that intend to provide investment advice to register under either federal or state law and banning applicants previously convicted of securities related offenses further protects investors against unethical management. Finally, applicants still are subject to § 6(a)(5) of the NSMIA, which imposes additional protections. Considering applicants already are a relatively

[93] *See* PRICEWATERHOUSECOOPERS ET AL., HIGHLIGHTS Q1 2002, MONEYTREE SURVEY, *at* http://www.pwcmoneytree.com/highlights.asp (last visited May 30, 2002).

[94] *See* PRICEWATERHOUSECOOPERS ET AL., HIGHLIGHTS Q3 1999, MONEYTREE SURVEY, *at* http://www.pwcmoneytree.com/highlights.asp (last visited Dec. 3, 1999).

self-selected group of sophisticated investors, the substantial protections offered by the Act are more than sufficient.[95]

(iii) Regulation Remains Formidable

The fact remains that the CACL is a compromise bill, the product of negotiation between deregulation proponents and the Department of Corporations.[96] For instance, the investor accreditation criteria still is formidable: $250,000 in tangible net worth and $5 million in funds to be invested.[97] A number of individuals, then, cannot invest their money in nascent businesses through these capital pools, even though they meet the "accredited investor" criteria of the Securities Act of 1933. Provisions such as the 80% resident requirement and proscription of issuing redeemable securities impose further restrictions upon the venture capital funds. Most importantly, concomitant regulation under the Investment Advisers Act of 1940 and the California Corporate Securities Law of 1968 make it highly undesirable to operate such a fund. Those laws, which are meant to regulate mutual funds, restrict the manager of a capital access firm to the fees normally earned by fund advisors—typically 1% to 2% of invested assets. This amount is low for a venture capitalist, considering the risk taken on by investing in fledgling enterprises. As a result, no formal applications have been made under the Capital Access Company Law to date.[98] Thus, despite the passage of the CACL, the amount of regulation imposed upon venture capital funds remains excessive and only the very wealthy can invest. In California, amendment proposals for further regulatory

---

[95] Venture capital poses significant barriers to entry that are not only financial but also skill-related. Operating a fund requires a great deal of investment savvy, risk tolerance, and management knowledge, not to mention considerable business connections.

[96] *See* Bristow & Petillon, *supra* note 5.

[97] *See* Capital Access Company Law, CAL. CORP. CODE § 28110 (West Supp. 2004).

[98] *See* Juan Hovey, *State's Limits on Capital Access Funds Means Missed Opportunities*, L.A. TIMES, July 14, 1999, at C6.

relief have been introduced, but have not been able to make it past the committee level in the legislature.[99]

IV. THE NET EFFECTS OF NSMIA, CACL, & OTHER RECENT LEGISLATION: HOW REAL IS REFORM?

As discussed, the only potential relief provided to venture capital funds by the NSMIA is the § 6(a)(5) exemption added to the '40 Act. Given the inaction by almost all state legislatures during the past six years, the efficacy of this exemption is dubious. California's CACL provides an additional indication of the legislation's strengths and drawbacks. The relaxation of the 100-shareholder restriction to 500 may extend access to capital, but the extension may not be economically significant.[100] Furthermore, the consensus behind California's CACL indicates that the NSMIA might allow for some measure of politically acceptable regulatory relief. Thus, from the CACL, one can ascertain that state regulated venture funds with greater access, at least in theory, may be achievable under the NSMIA.

However, in practice, the fact remains that venture capital funds still are subject to many restrictions imposed by the '40 Act and other federal securities laws. For instance, all investors must be accredited as defined in § 2(a)(15) of the Securities Act of 1933,[101] which means that they must have a net worth of at least $1 million or an income of at least $200,000 per year ($300,000 if married). In addition, the 80% resident requirement for the sale of securities,[102] the proscription of issuing redeemable

[99] *See* Bristow & Petillon, *supra* note 5.

[100] *See* Crawford, *supra* note 86. The removal of this restriction is magnified by the fact that a "look through" rule used to be applied to shareholders, which meant that persons or institutions with interests in the shareholder could be counted for the purposes of the restriction. *See* Smith, *supra* note 23.

[101] *See* 15 U.S.C. § 80a-6(a)(5)(A)(iii) (2000).

[102] This feature clearly benefits large states over small states which is a policy clearly lacking any rational basis.

securities, and the prohibition against purchasing securities offered by a '40 Act registered company all remain intact. Thus, under the NSMIA, the cash flows of a venture capital fund remain highly localized and access still is limited to wealthy individuals. Given these restrictions and the CACL's small impact thus far, it is highly questionable whether the NSMIA sufficiently democratizes venture capital in practice.

The present situation, several years after the NSMIA and the CACL, suggests that further legislative action likely will be necessary to improve capital formation. The NSMIA demonstrates that capital formation issues have found a place in a bipartisan, national legislative agenda. This development alone represents significant progress. Nevertheless, the relief given to venture capital funds by the government remains insufficient. So far, the NSMIA, coupled with state enabling statutes such as the CACL, have provided minimal relief in practice. Three of the four NSMIA capital formation reforms (intrastate exemption, qualified purchaser exemption, and added BDC flexibility) do not promote the relief the legislation purports to deliver.[103] Only California has utilized the § 6(a)(5) exemption and there have not been any applications for exemption under CACL. When considered with other relevant regulation during the past several years, particularly the NASDAQ and Rule 504 reforms discussed below, venture capital funds and new business development may not be receiving more relief—they may in fact be receiving less. In other words, although the NSMIA may have reduced federal regulation (already a questionable assumption in practice as discussed), gross regulation, including the portion affecting venture firms through securities markets and non-governmental organizations, may have increased. Other attempts to form and to allow access to more risk capital still do not mitigate the likelihood that venture capitalists, in terms of net

[103] *See* Statement on Signing the National Securities Markets Improvements Act of 1996, 32 WEEKLY COMP. PRES. DOC. 2038 (Oct. 11, 1996); *see also* 142 CONG. REC. S12,093-94 (1996).

regulation, are not much better off and could even be in a worse position than before the NSMIA and CACL.

A. NASDAQ Reforms

In 1994, the SEC and Justice Department launched an extensive investigation of the National Association of Securities Dealers ("NASD") guidelines[104] and NASDAQ market makers for inflating price spreads.[105] As a result, thirty trading firms agreed to a billion-dollar class-action lawsuit settlement, and the NASD agreed to reform its regulatory practices. However, critics of the reforms believe that they have produced harmful results and that the SEC failed to assess adequately their potential market effects.

More specifically, the federal intervention may have inhibited capital access by fledgling businesses listed on the NASDAQ and liquidity for venture capitalists seeking to profit on their investments.[106] While the SEC-mandated NASD reforms may decrease trading costs for individual investors by reducing price spreads, they also deter market makers from trading large quantities of small-capitalization companies' stock because it now is unprofitable.[107] Furthermore, incentives to provide research coverage have been eliminated for these entrepreneurial firms. As a result, institutions find it more difficult to take positions in such stocks, thus reducing liquidity for investors in emerging

---

[104] The NASD is the governing body that regulates the NASDAQ stock market.

[105] The "spread" is the difference between the "ask" and the "bid" price. The bigger the spread, the larger the profit market makers command on trades.

[106] Public offerings generally are the preferred exit strategy for venture capitalists. *See* Fenn, *supra* note 32, at 56 (noting that IPOs are desirable to the venture capitalist and the company's management alike because they not only bring the highest valuations but also preserve the firm's independence and provide it with continued access to capital).

[107] *See* Bethany McLean, *Did Nasdaq's Reforms Backfire?*, FORTUNE, Mar. 1, 1999, at 250 (noting that profits from NASDAQ market making "have gone from grossly lucrative to laughable").

companies.[108] A possible effect has been that small-cap stocks (under $300 million in market-capitalization) underperformed for several years, leaving companies without capital vital to their growth and venture capitalists without an attractive exit strategy from their investments.[109] Regardless, there has been a pervasive disappearance in the liquidity and research coverage of smaller NASDAQ issues since the reforms because the incentives for major market markers to deal no longer exist.[110] The implementation of decimal price quotations may exacerbate the problem, as spreads already have shrunk 40% since 1997.[111] For an illustrative chart see Table 6 *infra.*

B. Rule 504 of Regulation D Amendments

In 1999, the SEC reformed Rule 504 of Regulation D in order to combat "pump and dump" schemes in the micro-cap markets.[112] Rule 504 allowed companies to raise up to $1

---

[108] *Id.* (concluding that "[t]he problem is that for all their evil ways, market makers had—and have—a purpose: supporting small companies by providing trading, research, and access to capital, which in turn encourages big institutions to venture into these stocks").

[109] *Id.* ("the poor performance during the past couple of years in small- to mid-cap stocks is almost solely attributable to these Nasdaq reforms"). *But see* James F. Verdonik, *SEC Implements Reform of Microcap Markets*, THE NAT'L L.J., Sep. 6, 1999, at B10 (hypothesizing that the new regulations, while onerous to small companies in traditional industries, are likely to have only marginal effects on the ability of technology companies to raise capital).

[110] *See* Specialist Association, New York Stock Exch., Position on Market Structure Issues 4.

[111] *See id.* (stating that as price spreads have shrunk, so too have the number of market makers per small cap stock). For the SEC's decimal quotation directive, see Press Release, Sec. & Exch. Comm'n, SEC Orders Securities Markets to Begin Trading in Decimals on July 3, 2000; Decimal Pricing Implementation Plan Due in 45 Days (Jan. 28, 2000), *available at* http://www.sec.gov/news/press/2000-8.txt.

[112] The movie "Boiler Room" dramatized "pump and dump" schemes. Promoters receive a private placement of small-company shares. Brokers conduct massive cold-calling operations to tout the stock with unfounded rumors and to sell their shares to unsuspecting clients. As the shares are resold, the price and the volume of the shares explode upward because of

million per year through Small Corporate Offering Registrations ("SCOR") public offerings exempt from the federal registration requirements of the Securities Acts of 1933 and 1934, but subject to state registration requirements. The SCOR exemption had provided small companies with ability to raise a small amount of capital from the public markets. Such an exemption is important because registered offerings usually are too costly and time-consuming for most small businesses.[113] The 1999 amendments included applying the general solicitation ban on Rule 505 and 506 offerings to Rule 504 offerings and further restricting the resale of securities issued under Rule 504, making the smallest offering of securities more restrictive than anytime since 1953.[114] As a result, companies lost an important means to raise capital in an efficient, low cost manner. In 1998, there were approximately 3,000 Form D filings,[115] but the amount dropped sharply after 1999.[116]

This action occurred despite the NSMIA directive for the SEC to "also consider, in addition to the protection of investors, whether [subsequent] SEC rule-making action will

---

the small float (amount of shares outstanding). Once the stock blocks are sold off, investors are left with illiquid shares that can only be sold at a fraction of the purchase price. The promoters make out with the profits from selling the shares at high prices induced by artificial demand. *See* Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 33-7644, 64 Fed. Reg. 11,090 (Mar. 8, 1999) (publishing the amendments).

[113] The undue burden of registered offerings on small businesses prompted the development and expansion of the exemption, culminating in the 1992 reforms that made it virtually unconditional. *See* Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. L. 1, 4-5 (2001).

[114] *See id.* at 5.

[115] *See* Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 33-7644, 64 Fed. Reg. 11,090 (Mar. 8, 1999).

[116] *See* John Berlau, *Recession Shock*, INSIGHT ON THE NEWS, Dec. 31, 2001, at 12.

promote efficiency, competition, and capital formation" and be consistent with the NSMIA's requirements.[117] The SEC implemented these amendments despite its own admission that "we believe that the scope of abuse is small in relation to the actual usage of the exemption."[118] The move eventually prompted congressional hearings in 2001, as many legislators and business leaders felt that "by trying to eliminate the fraud of a few it [the SEC] threw the baby out with the bath water."[119] The amendments, however, currently remain in effect and, according to the General Office of Accounting, the estimated cost of compliance for a registered offering now totals $439,000 in legal and accounting fees—almost half the $1 million total exempted under Rule 504.[120]

C. Public Venture Funds and Angel Investors

One innovation has been the creation of state-run capital access funds run by private managers.[121] These funds solicit

[117] Donald Devine, *SEC Sleuths Beyond the Law?*, WASH. TIMES, June 26, 2001, at A16.

[118] Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 33-7541, 63 Fed. Reg. 29,168 (May 21, 1998).

[119] *SEC's Role in Capital Formation: Help or Hindrance?: Congressional Testimony Before the Subcomm. on Oversights and Investigations, House Comm. on Financial Services*, 107th Cong. 10 (2001) (prepared statement of James Steinkirchner, Co-Chairman of the National Small Public Company Leadership Council).

[120] *See* Berlau, *supra* note 116; *see also* Bradford, *supra* note 113, at 24-28 (discussing the significant costs of registration for small offering amounts and estimating them at 15-25% of the offering amount).

[121] California and Oklahoma have introduced the most notable of these funds. *See generally* Sonya Colberg, *Match Maker State Center Links Investors, Entrepreneurs*, TULSA WORLD, Oct. 16, 1999, *available at* 1999 WL 5416750; *see also* A.B. 482, 1999-2000 Gen. Assem., Reg. Sess. (Cal. 1999) (proposing the program in California). Despite the fanfare, the Oklahoma program has done little to match capital—its role has been almost entirely advisory. *See* Oklahoma Tech. Commercialization Ctr., Program Accomplishments, *at* http://www.otcc.org (last visited Jan. 15, 2000).

private investments and offer tax credits if the fund fails to achieve a certain rate of return.[122] These funds, however, remain subject to the "accredited investor" criteria of $200,000 annual income ($300,000 if married) and $1 million net worth.[123] For "angel" investors with the wealth to qualify, but who lack the desire to organize a venture fund, such programs provide a lower risk vehicle to help fledgling businesses that might not receive the attention of traditional venture capitalists. On the other hand, potential investors might not participate because of not only the accreditation criteria but also concerns that the quality of the management and portfolio companies may be inferior to those backed by traditional venture capitalists.[124] In fact, many of these funds failed during the 1980s for this reason and out of concerns over political considerations influencing investment decisions.[125] Finally, such funds constitute a relatively insignificant legislative remedy because federal securities regulation still oversees them and therefore limits public participation to wealthy individuals. As the discussion of SBICs in the section will also reveal, government-run venture programs have not achieved much success.

D. SBIC Reform

Because of the legislative attention it has received, the SBIC program, which was on the verge of being shut down by President Reagan and Congress in the mid-1980s, now shows promise in providing fledgling businesses with smaller

---

[122] *See* Colberg, *supra* note 121.

[123] *See id.*

[124] *See id.*

[125] *See* BELTZ, *supra* note 4, at 56-57; *see also* Rural Policy Research Institute, Public Involvement in Venture Funds: Lessons from Three Program Alternatives (Nov. 1999) (discussing the disadvantages facing public venture funds, particularly political influence, or the perception of it, interfering with investment and management decisions).

size venture capital investments.[126] In 1992, Congress, for the third time, reformed the SBIC program, which generated over $600 million in losses during the late 1980s.[127] As a result, SBIC investments finally returned to the level of its 1964 peak in 1995 (in inflation-adjusted dollars).[128] Most recently, Congress sought to improve the functionality of the SBIC program with the SBIC Technical Corrections Act of 1999. With the objective of making the SBICs "more efficient and responsive to the needs of small entrepreneurs,"[129] the legislation's co-sponsors introduced five corrections to the program.[130] The Act altered the interest rate the SBA charges SBICs, increased funding for the program by several

[126] The average investment size for SBICs is much smaller than of traditional venture capital firms—$1.3 million versus $8.9 million. *See Summary of SBIC Program Financing, at* http://www.sba.gov/INV/tables/1999/stats/sbicfy1.pdf (last visited Mar. 14, 2000) (presenting SBIC average investment levels)); *see also* PRICEWATERHOUSECOOPERS ET AL., MONEYTREE SURVEY, *at* http://www.pwcmoneytree.com/highlights.asp (last visited Mar. 13, 2000) (presenting traditional venture capital firm average investment levels).

[127] *See generally* Small Business Equity Enhancement Act of 1992, 15 U.S.C. § 661 (2000); *see also* BELTZ, *supra* note 4, at 9; Bristow & Petillon, *supra* note 5, at 411 (noting that the SBIC program became so discredited that there were legislative attempts to kill it and the SBA completely). The most significant aspect of the reforms was the shifting focus of the program from debt to equity based financing, in particular the removal of semiannual interest payments by SBICs on borrowed money prior to investment liquidation. *See* BELTZ, *supra* note 4, at 9.

[128] *See* Bristow & Petillon, *supra* note 5, at app. 4.

[129] *The Small Business Investment Company Technical Corrections Act of 1999: Hearing on H.R. 68 Before the House Committee on Small Business*, 106th Cong. 3 (1999) (introductory remarks by Rep. Nadia Velazquez, Ranking Member of the Committee and co-sponsor of the legislation).

[130] First, the Act changed the interest rate charged by the SBA to an SBIC to exclude any contingent obligations (such as options, warrants, etc.) of the small business to the SBIC. Second, the Act increased program funding by several million dollars. Third, the Act loosened the leverage planning restrictions for small SBICs. Fourth, the Act included "S" corporations in SBIC financing. Finally, the Act granted the SBA greater flexibility in issuing trust certificates to finance SBIC investments. *See id.* at 2.

million dollars, loosened leverage planning restrictions, included "S" corporations, and allowed more flexibility in trust certificate issuance.[131]

These modifications probably will not change the fact that traditional venture capital firms still exceed the total investments of SBICs by a huge margin.[132] Nor will they alter the fact that SBICs comprise an even smaller percentage of total venture capital investments, when angel investors and institutions are taken into account.[133] They might enable the SBIC program to have some small impact in capital formation, at the lower end of the venture capital market for startups requiring smaller investments.[134] In 2001, the average SBIC loan size was about $1 million, which is right in the "seed" range.[135] However, the SBICs have the disadvantage of consuming "considerable public capital as leverage."[136] Thus, this segment of the market

[131] *See id.*

[132] SBIC investments increased to $4.2 billion in 1999, while traditional venture capital (private partnerships) provided $30.3 billion in capital. *See* Small Business Admin., *All SBIC Program Licenses: Financing to Small Businesses Reported Between October 2001 and September 2002, at* http://www.sba.gov/INV/tables/2001/stats/allsbic1.pdf (last visited Mar. 14, 2000) (noting SBIC investment levels); *see also* Taylor, *supra* note 68 (noting traditional venture capital investment levels). In 2000, SBICs invested $5.5 billion, a 30% increase from 1999, suggesting that continued streamlining of the program has proven effective. *See* Bruce A. Kinn & Arnold M. Zaff, *VCs Tap New Funding Source: The SBIC Equity Leverage Program and the Reasons for Its Growing Popularity*, VENTURE CAPITAL JOURNAL, July 1, 2001, *available at* 2001 WL 2277780.

[133] *See* Taylor, *supra* note 67; *see also* BELTZ, *supra* note 4, at 56 (noting that SBICs comprise just 5% of all venture capital).

[134] *See The Small Business Investment Company Technical Corrections Act of 1999: Hearing on H.R. 68 Before the House Comm. on Small Business*, 106th Cong. (1999) (statement of Lee Mercer, President of the National Association of Small Business Investment Companies). There undoubtedly is need for these smaller investments, particularly in light of how competitive obtaining venture capital funding can be. *See id.*

[135] *See* Small Business Admin., *supra* note 132.

[136] *See* BELTZ, *supra* note 4, at 56. This disadvantage becomes marked when SBICs fail to achieve a certain level of returns, because the

may remain better served by incubators and private sector angel investors (discussed below).

E. Glass-Steagall Repeal

The financial modernization Act recently passed by Congress will allow bank-owned venture capital units to make unlimited investments in non-financial companies as long as they do not take management control.[137] This reform primarily benefits later-stage companies, as institutional venture capital funds supply nascent enterprises with less than 20% of their capital.[138] For example, early stage companies received only 19.2% of the venture capital invested in the first quarter of 2002.[139] Given the small amount of early-stage risk capital that large institutions provide, the repeal of the Glass Steagall Act may not have a significant impact upon the funding of small enterprises.

F. Immigrant Visas

One controversial measure to promote capital formation has been the immigrant investor program.[140] Wealthy foreigners who can invest $500,000 to $1 million in U.S. businesses to create ten jobs lasting ten years may obtain green cards.[141] The program, however, has failed to attract

---

government only receives its preferred return when the funds generate profits. Thus, like any leveraged portfolio, the government's investments and appropriations lose money faster when the markets decline.

[137] Prior to the Act, bank affiliated venture capital units could only invest in up to 5% of a nonfinancial company's stock.

[138] *See* Bristow & Petillon, *supra* note 5, at 432.

[139] *See* PRICEWATERHOUSECOOPERS ET AL., HIGHLIGHTS Q1 2002, MONEYTREE SURVEY, *at* http://www.pwcmoneytree.com/finance.asp?year=2002&qtr=1 (last visited May 28, 2002).

[140] This program was a little-noticed part of the Immigration Reform Act signed into law by President George Bush on November 29, 1990.

[141] *See* Walter F. Roche & Gary Cohn, *INS Insiders Profit on Immigrant Dreams*, BALTIMORE SUN, Feb. 20, 2000, at 1A, *available at* 2000 WL 4859731l; *see also* Andrew Blake & John H. Kennedy, *Citizenship for Only $1 Million*, AUSTIN AM.-STATESMAN, Sept. 22, 1991, at

the sizable investment levels of similar programs in Canada and Australia, with only 3,547 petitions granted to date (one-fourth the amount of the Canadian program).[142] Bureaucratic confusion and corruption has plagued the program, leaving immigrants without visas[143] and companies without the capital that they were promised.[144] Coupled with public distaste for the concept of purchasing citizenship, the program has been nothing short of a disaster, coming nowhere close to providing the $8 billion annually and 100,000 new jobs for American businesses as originally intended.[145] The similar program in Canada, which is much more extensive, also is on the verge of failure because of corruption and public outrage over fraud and other improprieties.[146]

G. New Private Institutions: Law and Management Consulting Firms

A notable trend in capital formation has been law and management consulting firms investing in their clients. The phenomenon became popularized among Silicon Valley law

---

C4, *available at* 1991 WL 4326225 (describing the program at the time it was proposed).

[142] Roche & Cohn, *supra* note 141. At the time of the passage of the Immigration Reform Act, the Canadian program already had attracted 12,074 business immigrants in five years. *See* Blake & Kennedy, *supra* note 141.

[143] Some immigrants have invested their money, only to be deported. *See* Roche & Cohn, *supra* note 141.

[144] *See id.* (describing how a number of businesses have failed because the capital that the government promised them either never arrived or was much smaller than anticipated).

[145] *See id.* (noting Sen. Paul Simons' support for the program during a 1986 Senate debate).

[146] *See* Terence Moore, *Citizenship for Sale*, WINNIPEG FREE PRESS, Sept. 16, 1999, at A12, *available at* 1999 WL 25318564; *see also* Andrew Mitrovica, *Immigrant Investor Plan Denounced as 'Massive Sham,'* GLOBE & MAIL, Sept. 15, 1999, at A1 (describing how auditors have uncovered widespread fraud in the program).

firms and now has spread to consulting firms.[147] Firms not only are obtaining equity positions in clients but also are evolving their services to become more similar to venture capital funds and incubators.[148] The lucrative nature of venture investing has propelled this growth, as quality start-ups hunger for cash and for value-added services such as legal representation and management consulting. Thus, traditional private institutions may be finding a way to meet the huge appetite for capital. This trend also may mitigate the problem of asymmetric information facing entrepreneurs, because attorneys and consultants are in a favorable position to recognize the value of their clients. Nonetheless, the size of these investments remains small, on par with those of angel investors and seed capital. Furthermore, these firms may become more risk averse, given the recent market downturn.

H. Incubators

In early 2000, the popular Internet magazine *Red Herring* noted that "the Internet has begun to bridge the considerable gap between the supply and demand of venture capital" through incubators that match venture and angel investor

[147] *See generally* Peter Elstrom, *Everybody into the Pool: Venture Capital is Drawing Cash Everywhere—Thanks to Amazing Returns,* BUS. WK., July 26, 1999, at EB58 (describing how consulting firms are starting to invest in clients); D.M. Osborne, *When is a Law Firm Not a Law Firm?,* INC., May 1998, at 82 (describing the operations of Venture Law Group).

[148] In law, consider not only Venture Law Group but also other Silicon Valley-based firms and even more traditional "white shoe" firms on the East Coast, which now are investing clients. For a good article on the structure and ethics of these investments, see Gwyenth E. McAlpine, *Getting a Piece of the Action: Should Lawyers Be Allowed to Invest in Their Clients' Stock?*, 47 UCLA L. REV. 549 (1999). In management consulting, there is an explosion not only of e-consulting firms that focus on startups but also of traditional firms developing incubator services. *See, e.g.*, Bain & Company, Bainlab Background, *at* http://www.bainlab.com (last visited Feb. 4, 2000).

capital to entrepreneurs.[149] For a fee, these incubators circulate business plans among potential investors, who provide the seed capital critical to start-ups. Internet incubators, such as garage.com, as well as other incubators provide entrepreneurs with smaller investments than traditional venture capital partnerships. In 1999, garage.com and dsm.com (now defunct) each matched over $100 million of venture and angel capital—and these companies were in their first year or two of operations.[150] At their peak, Idealab and publicly-traded CMGI each provided $1 billion in capital to fund portfolio companies.[151] The wild success of these operations turned sour because their investments only included companies in the collapsing Internet sector.[152] Prior to the recent downturn, regulation in this area produced notable friction, as the SEC struggled

---

[149] Incubator Issue, RED HERRING, Feb. 16, 2000, *at* http://www.herring.com/ipo/2000/0216/ipo-garage0216000.htm. Garage.com CEO Guy Kawasaki said,

> We are very excited to be included in the 1999 Upside Hot 100 Private Companies. Garage.com is filling an important need for both high tech startups and investors interested in the highest quality seed-stage investment opportunities. This award acknowledges the role that Garage.com is playing in the global trend towards the democratization of the private equity markets.

Press Release, Garage.com, Upside Magazine Names Garage.com Among 1999 Hot 100 Private Companies (May 14, 1999), *at* http://www.garage.com/pressreleases/990510.shtml.

[150] *See* Garage.com, Successes, *at* http://www.garage.com/successes.shtm (last visited Mar. 15, 2000) (noting Garage.com's 1999 investment levels).

[151] *See* Press Release, Idealab! Secures $1 Billion in Equity Financing, *at* http://www.idealab.com/news/pr031300.htm (describing Idealab!'s latest venture fund); *see also* Press Release, CMGI and @Ventures Launch New $1 Billion Technology Venture Capital Fund (January 24, 2000), *at* http://www.ventures.com/news/00/@v_tech.html (describing CMGI's latest venture capital fund).

[152] At one point, incubators were so successful that Bill Gates was briefly overtaken as the richest man in the world by the President of Softbank (a publicly-traded venture capital company), who had amassed a fortune of nearly $70 billion. *See* Taylor, *supra* note 67.

to develop cogent criteria for granting exemptive orders to the '40 Act for incubators.[153]

While temporarily obscured by economic conditions, diversified incubators, when combined with venture capital, and, perhaps most importantly, venture capitalists, may offer an important vehicle for venture investment.[154] For fledgling companies, incubators provide a one-stop solution to the entrepreneur's financing and support needs. However, the importance of the venture capitalist in selecting investments and in providing early management cannot be overstated. When publicly traded, they also allow widespread participation in venture investing for investors normally precluded by the accreditation criteria. Their recent popularity reflects their potential to tap the demand for capital by entrepreneurs in early stage companies as well as the demand to invest in ventures by angels. At the same time, the rise in their popularity also has highlighted the regulatory barriers that may be arbitrarily constraining them, as seen by the SEC's struggle to regulate them. Regardless, at the very least, the frequent attempts to create incubators demonstrate their allure as a means to democratize capital formation.

V. FOCUSED, COMPREHENSIVE, AND MODERNIZED REGULATORY REFORM: POLICY CONCERNS

A. The Policy Debate

An examination of the regulation of venture capital funds, then, reveals that the legislative effort to improve capital formation largely remains ad hoc and inconsistent in its

[153] *See* Meredith M. Brown, Michael P. Harrell & William D. Regner, *Internet Incubators: How to Invest in the New Economy Without Becoming an Investment Company*, 56 BUS. LAW. 273 (2000).

[154] Incubators in fact are not creations of the Internet boom, but have existed since 1959. For a full discussion of incubators, their history, and their merits, see Fredrick Burger, *Business Incubators: How Successful Are They?*, AREA DEV., Jan. 1999, at 76.

approach. Depression-era securities legislation designed to regulate financial institutions distinct from capital access companies still characterizes the basic framework of federal regulation. Until recently, congressional reforms generally have produced ineffectual exemptions (or inconsistent SEC exemptive orders in the case of incubators). Since the NSMIA and CACL, additional initiatives (such as state-sponsored venture funds, SBIC reforms, immigration visas, tax incentives, and allowing increases in institutional venture funding) reflect an imprecise legislative agenda to improve capital access. Thus, the flow of capital to new businesses still remains inadequately regulated. When the effect of the NASDAQ reforms is accounted for, an even stronger case may be made that entrepreneurs and the venture capitalists and angels that serve them require regulatory relief as much as they did prior to the NSMIA and the CACL.

A key challenge for the legislative branch is re-evaluating Depression-era securities regulation and balancing public policy concerns in a different era. Given the free market system of this country and its growing acceptance abroad, it is valid to question why the government should so strictly regulate sophisticated and highly competitive venture investors critical to the economic growth of the country. It is equally valid to ponder why *any* kind of investor should be denied access to participate in venture funding. Certainly programs which subsidize the richest among us are of questionable merit. In other words, the underlying purpose of the '40 Act (to protect investors) remains poorly effectuated by its provisions because they hamper venture capital. The cost of protection to the protected, and the result of the protection, need to be seriously re-evaluated.

Arguments for the protection of investors should not overlook the fact that well-tailored regulatory reform will not make venture managers any less subject to adequate criminal and civil penalties and their enforcement. More importantly, the government interest in safeguarding against fraudulent practices pretty clearly diminishes when it usurps the judgment of individuals, whether good or bad, as to how they invest their own money. In other contexts far more suspect than in venture funding, the government rightly allows people to make what others might consider bad investment decisions all the time.[155] To date, the political struggle to evaluate directly the "Depression mentality" and the potentially unbalanced allocation of public policy concerns underlying the federal regulatory structure of venture capital has spawned reform efforts that often produce ineffective, confusing, and counter-productive results.

Arguments that some people should be denied access to venture investing on the basis of risk and their lack of sophistication may persist. The explosion of venture capital was perhaps correlated with some "irrational exuberance" similar to what preceded the Great Depression and therefore it may not be proper to abandon the "Depression mentality" underlying some regulation too quickly. For example, the percentage of profitable venture-backed IPOs dropped to almost 10% in 1999 from almost 70% in 1982.[156] While the numbers of non-venture capital backed IPOs are only marginally better,[157] there might be concern that venture capitalists rushing companies to IPOs may leave the public holding the bag when they do not achieve sustained profitability.[158] This position is echoed by some economists, who suggest that the "home run orientation" of venture capital may bias investment toward breakthrough innovations and away from commercial follow-through.[159] Thus, "boosting venture capital, while it may lead to more start-ups, may in fact be detrimental for the national economy"[160] by misallocating investment capital into venture

[155] Consider lotteries, gambling, exotic car purchases, timeshares, condominiums, network marketing schemes, and recreational vehicles to name a few.

[156] *See* Taylor, *supra* note 67 (these figures are available in press releases at http://www.ventureeconomics.com).

[157] *Id.*

[158] *Id.*

[159] *See* BELTZ, *supra* note 4, at 35 (quoting economist Richard Florida).

[160] *Id.*

initiation instead of venture sustenance through research and development.

These concerns, while understandable, mischaracterize the venture capital market. First, venture backed stocks not only have outperformed the major indices, but also have demonstrated less volatility.[161] These key performance indicators suggest that venture capital, far from leaving the public "holding the bag," has provided superior returns with less risk to investors, even after their public offerings. Second, the economic reality is that the market will correct for any over-allocation of capital. Even the economist Richard Florida concluded that the distribution of capital is best left to the markets and opposes boosting venture capital through government programs because they are poorly run, not because too much venture capital could do harm to the economy.[162] Just like the financial markets, real estate, and various other business sectors, venture capital experiences booms and busts. Markets simply have their ups and downs. Finally, venture funding constitutes productive societal investment independent of cycles: during the last venture capital downturn in 1990-1992, some of the most successful companies in the country, such as Starbucks, McAfee, Intuit, Palm Computing, FTP Software, eFax, and Checkfree, received their Series A round of financing.[163] During the past three years, a peak, venture financing has exceeded the federal nondefense research and development budget.[164] Furthermore, the private actors allocating venture financing do not do so to lose money, and commercial success is what makes money for companies and venture capitalists alike.

[161] *See* Taylor, *supra* note 67 (presenting a graph from Venture Economics and the National Venture Capital Association that displays the quarterly returns of venture capital partnerships versus the NASDAQ from 1986-1999 and reveals the NASDAQ to be two to four times more volatile). The venture backed stock index (PVCI) outperformed the S&P 500, Dow Jones, and the NASDAQ with ten-year returns of 26.2% versus 15.3%, 15.4%, and 24.5%, respectively. *See id.*

[162] BELTZ, *supra* note 4, at 61-94.

[163] Taylor, *supra* note 67.

[164] *Id.*

Investing in frivolous ideas is not the rule for credible venture capitalists. However, their willingness to accept risk to fund unproven, yet promising, ideas provides society with the competitive laboratory to test those ideas, to invalidate bad ones, and to more rapidly implement good ones. By accelerating the development of a greater variety in consumer-selected innovations, venture capital benefits all citizens.

Thus, the main issue is not whether there is more venture investing than would be efficient, but how capital formation can be promoted, balanced with the policy concerns of investor protection and promotion of economic growth. The legislative analysis above, coupled with the opinions of most economists, reveals that government intervention will be most effective in deregulation, not in the creation of new programs. The poor track record of BDCs, SBICs, state-sponsored venture funds, and the federal immigrant investor program, particularly when contrasted with the success of private sector innovation, all evince this point. At the same time, Beltz notes that the political reality is that "despite its long history, the Washington venture capital debate has focused more on form than on substance, that is where a new program should be housed, who . . . gets control, and how the program should be structured."[165] Thus, redefining the political debate constitutes an important step. In this sense, the NSMIA and the CACL, regardless of their substantive merits, represent important progress because they have served to put regulation and capital access back on the legislative agenda and within the arena of local and national public debate.

Implementing effective regulatory relief is complicated. As the Task Force of Hedge Funds, an influential voice in the creation of NSMIA, noted, "any change . . . needs to be carefully reviewed to strike an appropriate balance between the public policy goals of (i) protecting investors, (ii) encouraging innovation and flexibility, and (iii) facilitating

[165] BELTZ, *supra* note 4, at 11.

capital formation."[166] Achieving a balanced approach to regulatory relief that is politically acceptable undoubtedly will take serious effort. Furthermore, it will require a continued, focused assessment of the rationales underlying regulation and our enterprise system. However, such an effort is necessary to provide capital for the small companies that drive economic growth.

B. Possible Solutions

The following legislative measures may represent possible methods of improving capital formation while balancing the underlying policy concerns of investor protection and promotion of economic growth.

1. Revising the Application of Investor Accreditation

Removing the "accredited investor" criteria for § 6(a)(5) exempt funds might be a controversial idea, but an exemption should be considered for angel investors. The current system limits the superior returns provided by venture investment to very wealthy individuals. Roughly 5 million of the 41 million individual investors and about 2% of American households meet this criteria.[167] Particularly in the era of informed individual investing, it seems unfair that a person of more modest means should be restricted from putting his money to work in the venture capital market, as long as adequate investor disclosures are made. Government-sponsored capital access funds probably would experience a swell of participation by investors, were the accreditation thresholds lowered. Income and investment thresholds for the managers or directors of venture funds could be maintained to ensure the solvency of funds and the sophistication of the general partners.

---

[166] *See* The Task Force on Hedge Funds, *supra* note 26.

[167] *See* Berlau, *supra* note 116; *see also* U.S. CENSUS BUREAU, PROFILE OF SELECTED ECONOMIC CHARACTERISTICS, HOUSEHOLD INCOME AND BENEFITS (2000).

2. Adjust the § 6(d)(1) Offering Exemption Amount Upward

As mentioned, the threshold of $10 million for § 6(d)(1) exempt offerings is too low to help venture capital firms raise money because the management fees of $250,000 would not even cover legal and other overhead costs necessary to begin the fund. Increasing the exemption aggregate amount to $100 million would be more appropriate. At $100 million, the first cut of management fees, applying the typical 2.5%, generates $2.5 million, providing a sufficient cushion for a fund to begin operations and to compensate the expert management required. Because of current regulations, the fund still would need to remain state-centric in issuing its shares, so states with lower concentrations of accredited investors or qualified potential partners may not benefit. Even in states without those problems, like California, share ownership could not exist outside the state boundaries—certainly a limiting factor. However, without an increase in the offering amount, the intrastate issue would be moot, as the exemption remains essentially useless based on the economics of this business. Essentially, the current exemption level regulates these funds out of existence.

3. The Intrastate Restrictions and State Oversight in § 6(a)(5)

The NSMIA grants the states the ability to charter capital access funds, which makes sense, since state legislatures are better acquainted with the local business landscape and their constituencies.[168] On the other hand, the exemption from the '40 Act is predicated upon operating primarily a state-centric venture fund, which contradicts the legislative intent of the NSMIA.[169] Given the globalization of financial markets and investing, softening the intrastate requirements seems logical. In particular, legislators representing smaller states should advocate such a change,

---

168 15 U.S.C. § 80(a)(6)(a)(5) (2000).

169 *Id.*

as the current law only benefits the largest states in terms of venture capital activity. It is paradoxical that all U.S. residents of age may gamble unlimited amounts in Nevada and New Jersey, while only a fractional amount of the same citizens, individuals residing in those states, may invest in venture capital there. One can cross the state line to gamble, but not to invest in America's entrepreneurs. Reducing or eliminating the 80% in-state securities offer restriction should be considered as long as out-of-state holders are sufficiently subject to state or federal securities regulation.

4. State Enabling Acts: Remove Concomitant Investment Advisor Regulation

As mentioned before, restricting the fees of venture fund operators to the level of mutual fund advisors serves as a major deterrent with no corresponding benefit. Venture capital operations require high levels of investment savvy, risk tolerance, management knowledge, and business connections—and managers should be compensated accordingly. State enabling statutes likely will not attract such professionals to form funds under the § 6(a)(5) exemption unless they can obtain the rewards that private venture capitalists in the traditional limited partnership structure can. Therefore, either exemptions should be created in the Investment Advisor Act and similar state legislation that improperly regulate venture funds as if they were mutual funds, or state enabling acts should be passed pursuant to the NSMIA omitting any provisions that impose such concomitant regulation. Doing so will dramatically increase the likelihood that quality venture managers will apply to form more "public" venture funds.

5. Proscription of Issuing Redeemable Securities

Another restriction that could be liberalized is the prohibition of issuing redeemable securities, which inhibits the ability of venture capitalists to obtain secondary financing for their funds. In other industries, the benefit of securitizing private contracts is available: mortgages, commercial paper, and credit card obligations are but three examples. The present situation is lose-lose: venture funds are not funded as well as they could be, resulting in less capital for emerging enterprises, and the middle-income investor misses out on investment opportunities. Venture capital funds may or may not constitute riskier investment vehicles. On the other hand, if individual investors have the freedom to day-trade options, stocks on margin, or futures on commodities, why should they be denied access to venture capital on the basis of risk? Furthermore, real estate finance, corporate debt, and credit card obligations often involve significant risks, yet securitized markets still exist for them. Regulation would be better suited if it focused on ensuring the accurate disclosure of the quality of the securities offered by venture funds. As long as there is adequate oversight of securities offerings, venture capitalists should be allowed greater freedom to fund their operations.

6. Revisiting NASD Reforms: Small Cap Markets

The under-performance of small and mid-sized companies constitutes a threat to capital access and venture investors. While a system in which a few market makers and "chop shops" exploit small investors is undesirable, the SEC needs to evaluate the market-wide effects of the NASD reforms in order to protect small investors without impeding the flow of institutional and private capital to hungering companies.[170] Otherwise, the implementation of decimal quotes may seriously undermine the small capital markets. Increasing public awareness of "pump and dump" schemes, advocating better investor education, and tightening enforcement could mitigate corruption without imposing such heavy regulatory burdens upon emerging companies and venture capitalists. California, in fact, already has undertaken sizable measures

[170] *See* McLean, *supra* note 107 (quoting the warning of Wayne Wagner, chairman of the research firm Plexus Group, that "if you start fiddling with the markets without a real comprehensive view, you think you're doing good when in reality you're doing bad").

to educate the investing public and to combat illegal boiler room operations.[171] The approach of regulators should be to better research the occurrence of fraud and price manipulations and then follow with targeted efforts, as opposed to implementing unwieldy rules that produce costs potentially greater than the perceived benefits.

7. Revise Rules 504 and 506: Create National General Solicitation Exemptions

The general solicitation ban on Rule 504 offerings should be eliminated because it unduly burdens entrepreneurs attempting to raise capital. Allowing entrepreneurs to advertise their offerings freely will enable them to focus more on building their businesses and less on constantly searching for accredited investor contacts, either through their own networks or through broker-dealers. The offerings themselves could still be limited to accredited investors only. In addition, the offering amount should be increased to $5 million, which will make the costs of pursuing such an offering worthwhile. Finally, the exemption should be federal and preempt state law in order to gain uniformity, as there currently is wide variation among state regulations governing this area.

VI. CONCLUSION

Comprehensive relief for the entrepreneur, venture capitalist, and angel investor remains elusive. Large-scale unmet demand requires further legislative innovation, including the removal of outdated regulations, to facilitate not only much-needed capital for fledgling enterprises but also access to the superior returns desired by many potential

[171] *See* Press Release, State of California Department of Corporations, Art Imitates Life in New Movie "Boiler Room" (Mar. 2, 2000), *at* http://www.corp.ca.gov/pressrel/nr0002.htm (describing how the Department is working with AARP and other groups to warn investors about telemarketing fraud, as well as setting up a multi-agency task force with a command center that will house permanent staff, resources, and information to combat illegal boiler room operations).

investors suitably equipped for the risk. Many middle- and lower-income Americans own significantly leveraged positions in real estate, with accompanying risks that dwarf the risk, and earn a fraction of the return, that their participation in a diversified portfolio of venture capital investments could offer. Competing policy concerns may make reform complicated and politically charged at times. However, federal and state legislatures can make improvements by measured recognition of the crucial role that venture capital plays in the growth of the economy. Synthesized, well-tailored regulatory relief has not occurred yet. The national growth of venture capital, largely available to only the richest few, will necessitate re-evaluating current reform and further developing legislative innovation in this area. Until further democratization occurs in venture capital, regulators may be unwittingly harming entrepreneurs, middle-income and lower-income Americans alike, while benefiting the wealthiest.

VII. APPENDIX

TABLE 1
HISTORY OF VENTURE CAPITAL COMMITMENTS AND INVESTMENTS (1969-2001)

Year	Capital Committed to Venture Capital Funds ($Millions)	Capital Invested by Venture Capital Funds ($Millions)
1969	171	n/a
1970	70	n/a
1971	70	n/a
1972	55	n/a
1973	40	n/a
1974	40	n/a
1975	35	n/a
1976	40	n/a
1977	39	n/a
1978	600	n/a
1979	250	n/a
1980	700	n/a
1981	1,300	n/a
1982	1,457	1,903
1983	4,540	3,675
1984	2,895	5,434
1985	3,324	3,861
1986	3,776	4,674
1987	3,571	4,971
1988	3,191	5,821
1989	5,202	5,800
1990	2,006	3,917
1991	1,215	2,909
1992	3,114	5,529
1993	3,996	5,584
1994	5,535	5,468
1995	6,296	5,928
1996	8,233	9,879
1997	10,399	13,064
1998	30,400	19,200
1999	59,200	52,400
2000	104,600	99,600
2001	40,600	36,500

Source: Bristow & Petillon Table 5, Venture Economics and National Venture Capital Association (1998-2001).

TABLE 2

Year	Number of New Partnerships	Average Size of New Partnerships ($Millions) (nominal)	Average Size of New Partnerships ($Millions) (in 2001$)
1980	26	28	52.1
1981	40	24.3	43.9
1982	40	27.4	48.0
1983	76	39.1	66.6
1984	83	38.4	63.5
1985	59	32.8	52.6
1986	59	51.6	80.4
1987	78	43.7	66.1
1988	54	44.3	65.1
1989	64	47.6	67.9
1990	21	52	72.0
1991	5	33.3	44.8
1992	13	137.8	179.8
1993	18	32	40.5
1994	25	48.7	59.9
1995	36	69	82.4
1996	54	56.2	65.2
1997	79	52	58.5
1998	82	52.6	57.5
1999	146	98.6	104.6
2000	195	71.5	73.6
2001	86	53.7	53.7

Source: Bristow & Petillon Table 7, Venture Economics (1991-2001)

TABLE 3
DISTRIBUTION OF WEALTH AMONG U.S. HOUSEHOLDS

Income and Benefits (Using Year 2000 Inflation-Adjusted Dollars)	Number of Households	Percentage of Households
Less than $10,000	10,214,029	9.55%
$10,000 to $14,999	7,114,480	6.65%
$15,000 to $24,999	14,239,749	13.32%
$25,000 to $34,999	13,745,824	12.86%
$35,000 to $49,999	17,386,908	16.26%
$50,000 to $74,999	20,466,421	19.14%
$75,000 to $99,999	10,728,322	10.04%
$100,000 to $149,999	8,315,735	7.78%
$150,000 to $199,999	2,397,037	2.24%
$200,000 or more	2,297,314	2.15%
Total households	**106,905,819**	**100.00%**
Median household income	$ 41,433	
Mean household income	$ 55,378	

Non-Accredited Investor Households*	**104,608,505**	**97.85%**

vs.

Accredited Investor Households*	**2,297,314**	**2.15%**

* By income criteria of the Securities Act of 1933: natural persons with income over $200,000 / year (Note: if married and joint filing income criteria of over $300,000 / year were applied, it would reduce the number of accredited investor households to an even smaller number)

Source: U.S. Census Bureau, 2000 Data

TABLE 4

NSMIA CAPITAL FORMATION REFORMS & OUTCOMES

REFORM	CITATION	PRIOR REQUIREMENTS	AMENDED REQUIREMENTS	OUTCOME
Intra-State Exemption	15 U.S.C. § 80a-6(d)(1), (2)	$100,000; intrastate	$10 million; intrastate	Ineffectual: not used
Qualified Purchaser Exemption	15 U.S.C. § 80a-3(c)(7); 2(a)(51)(A)	n/a	Natural person - $5M Institution - $25M	Ineffectual: partners that wealthy use <100 rule
§ 6(a)(5) Exemption	15 U.S.C. § 80a-6(a)(5)	n/a	State regulation, 80% of securities intrastate, accredited investors	CACL passed; no other states follow suit
Added BDC Flexibility	15 U.S.C. §80a-2(a)	Strict debt to equity ratios; must provide managerial assistance	More debt issuance; invest in companies w/o providing managerial help	Negligible: BDC investing continues decline; many SBIIA restrictions remain

TABLE 5

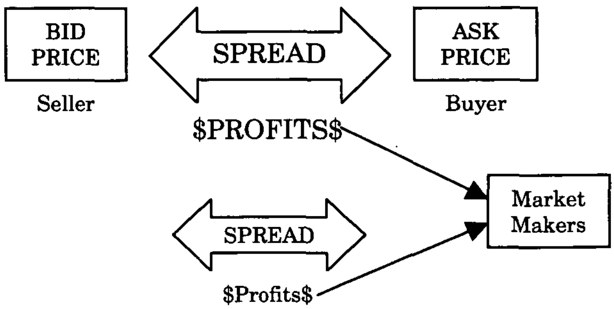
VENTURE CAPITAL ANALYSIS FOR TOP TEN STATES FOR 2001

State	Venture Capital Investments ($Millions)	Venture Capital (# of Deals)	Population (000s)	Venture Capital Per Capita ($)	Population Per Deal	Gross Personal Income ($Billions)	Venture Capital Per GPI (%)
California	13,384.3	1014	33,872	395	33,404	1,127.4	1.19
Massachusetts	3,675.7	243	6,349	579	26,128	247.8	1.48
Texas	2,556.0	200	20,852	123	104,260	607.5	0.42
New York	1,767.0	167	18,976	93	113,629	682.0	0.26
New Jersey	1,266.1	88	1,819	696	20,670	323.7	0.39
Colorado	1,112.2	70	3,406	327	48,657	145.6	0.76
Maryland	896.6	52	5,296	169	101,846	187.9	0.48
Virginia	805.6	103	7,079	114	68,728	232.1	0.35
Washington	773.1	91	5,894	131	64,769	189.1	0.41
Illinois	698.4	75	12,419	56	165,587	408.9	0.17
All Others	6,735.7	695	165,460	41	238,072	4,469.0	0.15
TOTAL	33,670.7	2798	281,422	120	100,580	8,621.0	0.39

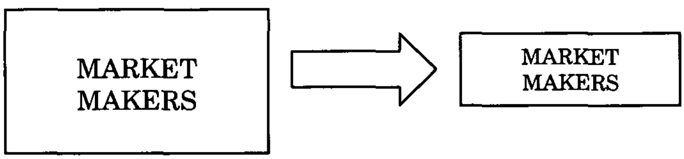
Sources: 2000 U.S. Census Bureau Statistics, PwC Moneytree Report 2001, and Bureau of Economic Analysis Personal Income Data

TABLE 6
ASSERTED EFFECTS OF NASD REFORMS

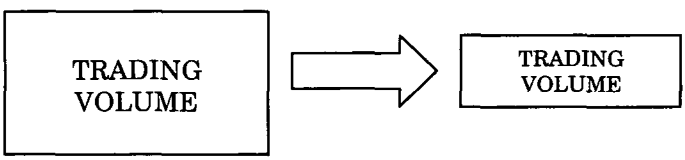
1. As spreads shrink, the profits of market makers are reduced.



2. As profits diminish, fewer market makers trade shares.



3. As less market makers trade shares, liquidity decreases.



4. As liquidity decreases, the access of small companies, and venture capitalists invested in them, to the markets declines.