

## Is Silicon Valley a Systemic Risk?

*Treasury decides to treat venture capitalists like hedge funds.*

by James Freeman

The Obama administration wants to regulate venture capital firms to prevent systemic risks. Silicon Valley residents are scratching their heads and asking: What risks? The rest of us should ask why Washington is targeting a jewel of the American economy that had nothing to do with the housing bubble.

The confusion began when Treasury Secretary Timothy Geithner recently told Congress that large venture capital (VC) firms should be forced to register with the Securities and Exchange Commission (SEC), and submit regular reports on their investors and portfolios. Data collected by the SEC would then be shared with a new risk regulator to ensure that VCs aren't "a threat to financial stability."

Since then, venture investors have been trying to solve the mystery of how they could possibly threaten the financial system. Their work involves very little banking. Venture firms raise equity from wealthy investors to buy ownership stakes in small companies. The VCs and the companies in which they invest use little or no debt.

"I cannot imagine any venture fund being of a size to pose 'systemic risk,' so they either don't understand the nature of the business, or by including this provision they are sharing that their agenda is not the overt one disclosed," says Jack Biddle of Novak Biddle Venture Partners. What Washington needs to understand is that bank-style regulation could destroy the culture that created the microprocessor.

In justifying new SEC registration requirements, Mr. Geithner said that Bernie Madoff's Ponzi scheme demonstrated that investors need more protection. He didn't mention that Madoff's firm was registered with the SEC as an investment adviser and had also been regulated by the SEC for decades as a broker-dealer. Also, Madoff was not running a venture firm.

The entire venture capital industry is smaller than the Madoff fraud. VCs invest a total of \$30 billion each year, far less than one-tenth of 1% of U.S. financial transactions. Venture investors -- affluent individuals and institutions -- are putting up equity and know that they can lose it all. SEC regulation could have the same negative impact on them that it had on Madoff's investors: creating an illusion of safety in what is an inherently risky endeavor. Or the regulation could become so severe that it actually does eliminate risk from venture investing, killing the innovative ideas that can only be funded by risk-takers.

The fact that VC money is small potatoes compared to Wall Street money doesn't mean we wouldn't notice if the industry were regulated out of existence. Venture investments helped build Intel, Apple, Google, Amazon and Cisco, to name just a few. Is Mr. Geithner sure that he has a better model?

Since the Treasury secretary lumped venture capital into a category with hedge funds, there's a question of whether something has been lost in translation between Washington and Silicon Valley. Mr.

Geithner says that he needs to make sure that private investment firms are not overleveraged. But leverage is such a small factor in the venture world that the trade association for venture capital firms doesn't even collect data on it. Responding to the Treasury plan, the National Venture Capital Association is now seeking more information. Will they discover dangerous levels of debt piled on such shaky foundations? Don't bet on it.

Greg Becker is the president of Silicon Valley Bank, a leader in providing financing to venture-backed companies. He says a typical start-up client will raise perhaps \$10 million in equity investments from VCs. His bank will lend perhaps \$1 million or \$2 million at high rates on a short-term basis only if the bank expects the young company to get another round of venture investment. Every dollar loaned is secured against all of the assets of the start-up. Most of these loans are paid back, and even when a start-up goes bust, he reports that the \$10 million equity investment has usually created enough enterprise value for his bank to recover its principal.

At the next level of growth, when companies have perhaps \$20 million of annual revenues but still negative cash flow, he'll loan perhaps \$4 million or \$5 million for working capital, equal to the company's quarterly accounts receivable, if he thinks the entrepreneurs will be able to use the funding to win a big client. Even when venture-backed firms become cash-flow positive, his bank is still only loaning limited amounts of money based on the firm's accounts receivable, and always secured by the firm's assets. Loans to venture-backed firms never account for more than 10%-11% of the bank's business.

For anyone concerned about systemic risk, the dot-com bust of 2000-2002 has already provided the ultimate stress test. Mr. Becker says his firm was never threatened, and neither were the other banks that provide such financing.

Many start-ups don't use debt at all. After all, how many people want to lend to a business without stable cash flows? For the ventures that do use debt, many of them use less than Mr. Becker's clients. Steve Harrick of Institutional Venture Partners says that even companies in his portfolio with \$50 million in revenues will typically limit borrowing to \$2 million or \$3 million for working capital. And at the level of the venture firms, there's a reason they raise equity instead of debt. Who would lend large sums to somebody investing in firms without profits or even revenues?

The only people threatened when a start-up goes bust are its small group of employees and investors, and they wouldn't have it any other way. Says Mr. Harrick, "You've got people willing to take risks. In fact, they need to have a tolerance not just for risk, but for the potential of outright failure."

If our economic system is to thrive, venture capital is exactly the place where we have to encourage risk. In pursuit of innovations that will enrich themselves and the world, employees at start-ups accept low

pay and reputational risk, while well-heeled investors accept the possibility of losing every nickel of their investment.

Attempts to limit risk pose a systemic threat to American technology. Venture capitalists, mainly veterans of the tech industry, are deeply involved in the companies they back, often helping to recruit each of the key employees at a start-up. This hands-on feature of venture investing means that innovative companies and their backers tend to cluster in areas like Silicon Valley. If the VCs move offshore, that's probably where the next generation of companies will be born.

Even if one wishes to be paranoid about systemic risks, it's hard to imagine how tiny tech companies could be ground zero in a future credit bubble. The politicians aren't driving capital into this business. Fannie Mae and Freddie Mac don't provide cheap financing to VCs. Major credit-ratings agencies don't grade start-ups, so there will be no government-distorted judgments of creditworthiness. Neither VCs nor the companies they fund issue bonds or CDOs or CLOs. There's no Technology Community Reinvestment Act. Moral hazard? Not in Silicon Valley. No tech-company founders or VCs could possibly believe they are too big to fail.

Washington-created failure is what riles Cypress Semiconductor CEO T.J. Rodgers. In a recent email, he notes that this isn't the best moment in history to add another burden to America's tech industry. Very few start-ups have gone public in recent years, thanks in part to the multimillion-dollar compliance costs imposed by the Sarbanes-Oxley law in 2002, the last time Congress sought to re-regulate corporate finance.

Says Mr. Rodgers, "First, Sarbanes-Oxley mandated byzantine corporate bureaucracy to 'protect' investors. Then, the SEC damaged the Silicon Valley economy by forcing companies to count stock options twice, both as dilution and as expense. As a result, Silicon Valley, for decades the bright spot of the American economy, produced only one [initial public offering] in all of 2008. Now, Geithner wants to regulate venture capital firms to protect us some more. It's like watching children deface an economic work of art."