Private Equity and Venture Capital:
What's the Difference?*
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I. Introduction

Private equity and venture capital spur discussion in national political campaigns,[1] in debates about tax policy,[2] and, at least in the case of venture capital, in thinking about the role of entrepreneurship in university culture.[3] Yet despite considerable press coverage about private equity ("PE") and venture capital ("VC") writ large, comparatively little has been written about how they differ from one another. Technically speaking, "private equity deals are simply deals that are not available for public participation"—this includes venture capital, angel investing, hedge funds, and buyout funds.[4] In the strictest sense, then, "private equity" encompasses a wide range of firms doing different types of deals, be it Kohlberg Kravis Roberts ("the quintessential private equity firm"[5] with tens of billions under management[6]) or Kleiner Perkins Caufield & Byers ("one of Silicon Valley's oldest and most prestigious venture capital firms"[7]).

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* The Silicon Flatirons Roundtable Series on Entrepreneurship, Innovation and Public Policy is sponsored by Brad Feld, Managing Director of the Foundry Group. Over a dozen Silicon Flatirons Roundtable Reports—on topics including private equity, internet governance, cloud computing, the future of the legal practice, and many more—can be found at http://www.silicon-flatirons.org/publications.php?id=report. Special thanks to Charles Sommers, Attorney-Adviser in the Securities & Exchange Commission, Division of Trading and Markets, for his assistance and suggestions on this Report.

[1] Kevin Roose, *Private Equity's YouTube Defense*, DEALBOOK, Feb. 24, 2012, http://dealbook.nytimes.com/2012/02/24/private-equitys-youtube-defense/.

[2] N. Gregory Mankiw, *Capital Gains, Ordinary Income and Shades of Gray*, N.Y. TIMES, Mar. 3, 2012, http://www.nytimes.com/2012/03/04/business/capital-gains-vs-ordinary-income-economic-view.html?_r=2.

[3] Ken Auletta, *Get Rich U.*, THE NEW YORKER, Apr. 30, 2012, http://www.newyorker.com/reporting/2012/04/30/120430fa_fact_auletta?currentPage=all.

[4] Jason Mendelson, *What is the Difference Between 'Venture Capital' and 'Private Equity?*, ASK THE VC (Feb. 10, 2007), http://www.askthevc.com/wp/archives/2007/02/what-is-the-difference-between-venture-capital-and-private-equity.html. *See also Private Equity Industry*, CALPERS, http://www.calpers.ca.gov/index.jsp?bc=/investments/assets/equities/aim/pe-glossary.xml#P (last visited June 26, 2012). "Private equity provides capital to enterprises not quoted on a stock market. Private equity can be used to develop new products and technologies, to expand working capital, to make acquisitions, or to strengthen a company's balance sheet. It can also resolve ownership and management issues. A succession in family-owned companies, or the buyout and buy-in of a business by experienced managers, may be achieved using private equity funding."

[5] Roger Lowenstein, *Raise the Tax on Private Equity*, BUSINESSWEEK, Aug. 5, 2010, http://www.businessweek.com/magazine/content/10_33/b4191007692750.htm.

[6] KKR & Co. L.P., Registration Statement (Form S-1) (July 3, 2007) http://www.sec.gov/Archives/edgar/data/1404912/000104746907005446/a2178646zs-1.htm.

[7] Zachary Coile, *Gore Joins Valley's Kleiner Perkins to Push Green Business*, SFGATE, Nov. 13, 2007, http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2007/11/13/BAUCTAV4I.DTL; *see also Private Equity Industry*, CALPERS, http://www.calpers.ca.gov/index.jsp?bc=/investments/assets/equities/aim/pe-glossary.xml#V (last visited June 26, 2012). "Venture capital is, strictly speaking, a subset of private equity and refers to equity investments

But underlying the sense of "private equity" as a broad category comprising many different investment types is a more nuanced dichotomy in which PE and VC connote different deal types, cultures, and regulatory treatment.[8] The "traditional" understanding of PE as distinct from VC[9] is a useful basis for exploring how these asset classes really differ from one another. According to this traditional interpretation, "VC" designates "investments in early 'startup' companies. These deals [are] generally regarded as too high-risk and too early in their life cycles to interest other PE players."[10] "PE," on the other hand, often refers to bigger funds that do later-stage deals.[11] Another commonly touted distinction between VC and PE is the use of leverage;[12] unlike PE, VC generally does "not use derivative transactions or leverage."[13] Accompanying these disparities in deal size, investment stage, and use of leverage is a stereotype that "venture capital is viewed as a creative industry, while the world considers private equity as finance, money men who do not create."[14] Are these distinctions stable and concrete, or are they permeable and, indeed, unreliable?

On March 6, 2012, the University of Colorado Law School's Silicon Flatirons Center convened an invitation-only private Roundtable discussion with nationally prominent venture capitalists, private equity managers, deal attorneys, investment advisors, and professors to

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made for the launch, early development, or expansion of a business." A new twist in recent years, of course, is private equity firms that are themselves publicly traded ("Taking such a fund public may seem like an oxymoron—after all, private equity funds typically buy public companies listed on exchanges, take them private, turn them around and cash out...[i]t opens private equity up to a whole new group of investors.") Heather Timmons, *Opening Private Equity's Door, at Least a Crack, to Public Investors*, N.Y. TIMES, May 4, 2006, http://www.nytimes.com/2006/05/04/business/worldbusiness/04place.html.

[8] *See*, *e.g.*, *SEC Issues Final Rules Implementing Dodd-Frank Amendments to the Investment Advisers Act of 1940*, DAVIS POLK & WARDWELL (June 29, 2011), http://www.davispolk.com/files/Publication/4c1a63de-64be-4051-a955-00faeaf7fe53/Presentation/PublicationAttachment/0c0cb405-27c8-451d-abaf-06c40e076bc0/062911_Investment_Advisers_Dodd_Frank_Final_Rules.pdf. "In contrast to private equity funds, according to the SEC, venture capital funds typically make long-term investments in smaller companies or early-stage companies that are held privately with the goal of eventually selling the companies or taking them public."

[9] Mendelson, *supra* note 4.

[10] *Id*.

[11] *Id*. For a useful overview of the landscape of alternative investments including private equity, venture capital, and hedge funds, *see* ANDREW METRICK, VENTURE CAPITAL AND THE FINANCE OF INNOVATION 6-9 (2007).

[12] "Leverage is the use of various financial instruments or borrowed capital, such as margin, to increase the potential return of an investment." Alternatively, it is "the amount of debt used to finance a firm's assets. A firm with significantly more debt than equity is considered to be highly leveraged." *Leverage*, INVESTOPEDIA, http://www.investopedia.com/terms/l/leverage.asp#axzz1v44QNgdS (last visited June 26, 2012).

[13] *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Hearing before H. Comm. on Financial Services*, 111th Cong. 14 (2009) (testimony of Terry McGuire on behalf of the National Venture Capital Association).

[14] Steven M. Davidoff, *In Silicon Valley, a Culture Clash Sullies a Romance*, DEALBOOK, July 5, 2011, http://dealbook.nytimes.com/2011/07/05/in-silicon-valley-a-culture-clash-sullies-a-romance/.

discuss private equity and venture capital (the "Roundtable"). Moderated by Brad Bernthal, an Associate Professor at Colorado Law School, the Roundtable considered key questions about the differences and similarities between private equity and venture capital, including (a) how the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), in particular section 203(l)-1, will impact private investment funds and capital deployment and to what extent it will constrain firms' operational flexibility; (b) whether PE and VC are "as different as night and day"[15] (culturally or otherwise) or if they exist on a spectrum; and (c) what is next in terms of regulatory treatment implicating definitional challenges surrounding PE and VC.

Roundtable discussion and accompanying research yield several key takeaways covered in this report (the "Report"):

- **Dodd-Frank will impose costs on both PE and VC firms, but only will change how a small subset of firms actually operates.** Rule 203(l)-1 will impose administrative and compliance burdens for registered firms and also will constrain firms' flexibility by limiting the types of deal structures that they might use.

- **The PE/VC distinction is a complex assessment; the use of leverage and certain operational differences suggest grounds for delineation, but differences between PE and VC largely exist on a spectrum.** The perception of a sharp culture clash ignores the many nuanced shades of PE and VC, but the issues of leverage and how each industry approaches regulation suggest that at least some differences are more pronounced.

- **The next major regulatory challenge implicating the PE/VC distinction will be legislation concerned with systemic risk (such as the Volcker rule).** Against a backdrop of fears about systemic risk, the PE/VC distinction will feature in questions of federal rulemaking and regulatory gamesmanship, but Roundtable participants were adamant that neither PE nor VC, however defined or distinguished from one another, meaningfully pose systemic risk.

This Report addresses each major point in turn, placing particular emphasis on the Dodd-Frank section 203(l)-1 definition of "venture capital fund," what the definition means for how funds operate and deploy capital, and how it informs understanding of the PE/VC distinction more generally.

II. "Venture Capital Fund" in Dodd-Frank: Definition and Impact

[15] Jennifer Rossa, *Regulatory Viewpoints: Private Equity v. Venture Capital*, PRIVATE EQUITY BEAT, July 16, 2009, http://blogs.wsj.com/privateequity/2009/07/16/regulatory-viewpoints-private-equity-vs-venture-capital/.

Roundtable discussion about the definition of "venture capital fund" in Dodd-Frank implicates two considerations: (a) an overview of the definition and its regulatory significance, and (b) the definition's impact on both private equity and venture capital funds. These issues further inform debate about the difference between venture capital and private equity, covered in Section III.

A. "Venture Capital Fund" Defined

Although Dodd-Frank "spans over 2,300 pages and affects almost every aspect of the U.S. financial services industry,"[16] of particular interest to Roundtable participants was an amendment to the Investment Advisers Act of 1940 ("IAA"),[17] section 203(l)-1 (the "venture capital exemption" or "the exemption").[18] The venture capital exemption defines "venture capital fund" and provides that an investment adviser that solely advises venture capital funds is exempt from registration under the IAA.[19]

The IAA regulates certain kinds of investment advisers (such as advisers to hedge funds, to private equity funds, and to other types of pooled investment vehicles[20]), requiring them to register with the SEC and "conform to regulations designed to protect investors."[21] As the Securities and Exchange Commission ("SEC") explains, the venture capital exemption is "intended to distinguish advisers to 'venture capital funds' from advisers to 'private equity funds,' for which Congress did not provide an exemption" from registration under the IAA.[22] The venture capital exemption defines a venture capital fund as a fund that:

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[16] William Sweet, *Dodd-Frank Act Becomes Law*, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (July 21, 2010), http://blogs.law.harvard.edu/corpgov/2010/07/21/dodd-frank-act-becomes-law/.

[17] The IAA "regulates investment advisers. With certain exceptions, this Act requires that firms or sole practitioners compensated for advising others about securities investments must register with the SEC and conform to regulations designed to protect investors." *Investment Advisers Act of 1940*, SEC. & EXCH. COMM'N, http://www.sec.gov/about/laws.shtml#invadvact1940 (last visited June 28, 2012).

[18] *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers*, SEC. & EXCH. COMM'N Release No. IA-3222.

[19] DAVIS POLK & WARDWELL, *supra* note 8.

[20] "Pooled funds" are funds "from many individual investors that are aggregated for the purposes of investment...Investors in pooled fund investments benefit from economies of scale, which allow for lower trading costs per dollar of investment, diversification and professional money management. *Pooled Funds*, INVESTOPEDIA, http://www.investopedia.com/terms/p/pooledfunds.asp#axzz1vLo7gdGV (last visited June 28, 2012).

[21] *Supra* note 17.

[22] DAVIS POLK & WARDWELL, *supra* note 8. *See also* Release, *supra* note 18 at 24.

i. immediately after the acquisition of any asset, other than qualifying investments or short-term holdings, holds no more than 20 percent of the amount of the fund's aggregate capital commitments in "non-qualifying investments";
ii. does not borrow or otherwise incur leverage apart from a limited amount of short-term borrowing (excluding certain guarantees by the fund of qualifying portfolio company obligations);
iii. does not offer investors redemption or other liquidity rights except in extraordinary circumstances,
iv. represents itself as pursuing a venture capital strategy to investors and prospective investors; and
v. is a private fund (is not registered under the Investment Company Act).[23]

The first two elements of the definition—"non-qualifying investments" and the use of debt—are particularly important touchstones not only for understanding the exemption itself, but also for their impact on actual PE and VC operations.

The requirement that a venture capital fund hold no more than 20 percent of the fund's aggregate capital commitments in "non-qualifying investments," merits further explication, particularly insofar as some Roundtable participants voiced concern about how often a fund must measure the percentage of its holdings that constitute non-qualifying investments. If a fund is to meet the definition of "venture capital fund," the value of non-qualifying investments held by the fund cannot exceed 20% of the value of the fund's aggregate capital commitments. Non-qualifying investments include non-convertible debt, publicly traded securities, or shares of other private funds.[24] Crucially from the perspective of a VC fund with a portfolio company that goes public, "under the definition, a venture capital fund may continue to treat as a qualifying investment any previously directly acquired equity security of a portfolio company that subsequently becomes a [publicly traded] company."[25] Regarding the calculation of this 20% basket, a fund need only to calculate the percent limit at the time it acquires a non-qualifying

[23] 17 C.F.R. § 275.203(l).
[24] DAVIS POLK & WARDWELL, *supra* note 8.
[25] Release, *supra* note 18 at 35-6. *See also* 17 C.F.R. § 275.203(l)-1(c)(4)(i) (defining a qualifying portfolio company as any company that *at the time of any investment* by a venture capital fund is not a reporting or foreign traded company). (Emphasis added.)

investment, other than short-term holdings.[26] After the acquisition of a non-qualifying investment, the fund does not need to dispose of a non-qualifying investment simply because of a change in the value of the investment.[27] To determine if a fund satisfies the 20 percent limit for non-qualifying investments, the fund may use either historical cost or fair value, as long as the same method is used for all investments over the term of the fund.[28]

Roundtable discussion also helped distill the importance of debt in the exemption. Ken Fugate, Founder, SVP and Managing Director at Square1 Bank encapsulated the exemption's treatment of debt:

> The use of debt determines whether a firm would be a VC or not under the definition; if debt is used for operating capital, working capital, or capital expenditure financing—all things to finance company growth—that is qualifying [meets the definition]. But using debt to buy out another investor or founders or using it to return capital to equity investors who are funding that round would mean it is not qualifying."[29]

These technical aspects concerning non-qualifying investments and debt—important in their own right as a basis for understanding of the PE/VC distinction—informed Roundtable discussion about the operational impact of the venture capital exemption.

B. The Exemption's Impact on Firms

Several Roundtable participants expressed the view that the "SEC did a decent job of getting it right" in defining venture capital funds as it does. Others were less sanguine, however, expressing frustration that the venture capital exemption (and Dodd-Frank more generally[30]) will impose administrative and operational costs for exempt and non-exempt firms alike.

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[26] Release, *supra* note 18 at 27.

[27] *Id*. "A qualifying fund, however, could not purchase additional non-qualifying investments until the value of its then-existing non-qualifying investments fell below 20 percent of the fund's committed capital."

[28] *Id*. at 30.

[29] *See*, *e.g.*, DAVIS POLK & WARDWELL, *supra* note 8. "The final rule excludes companies that both incur leverage in connection with the investment by the venture capital fund and distribute the proceeds of any such borrowing (or debt issuance) to the venture capital fund in exchange for the fund investment...The SEC notes that this approach would not exclude companies that borrow in the ordinary course of business or prevent an eligible venture capital fund from providing financing or loans to a portfolio company (provided the financing meets the definition of equity security or is made subject to the 20% limit for non-qualifying investments)."

[30] Rand Lewis of Centennial Ventures remarked of another Dodd-Frank provision, "this [Dodd-Frank] affects the size of fund we could raise." Dodd-Frank contains Rule 203(m)-1, which "under the Advisers Act generally provides an exemption from registration for an investment adviser solely to private funds that has less than $150 million in assets under management in the United States." *See*, *e.g.*, *SEC Adopts Rules Implementing Dodd-Frank Investment Adviser Exemptions and Registration Requirements*, WILLKIE FARR & GALLAGHER (June 30, 2011),

Brad Feld and Jason Mendelson, Managing Directors at the venture capital firm Foundry Group, helped quantify the burden required for a firm to avail itself of the exemption. A firm that files as exempt[31] needs to fill out the roughly forty-page Form ADV Part 1A annually;[32] non-exempt firms must file not only Form ADV 1A but also file additional parts to Form ADV as well as any amendments "promptly" if certain reported information changes.[33] Mendelson estimated that compliance for larger firms not exempt from registration could cost as much as $100,000 to $200,000 annually. Roundtable participant Tad Kelly, Managing Partner at CHB Capital Partners, decried the registration cost that Dodd-Frank will impose on lower middle market PE firms. As Kelly observed, "this hurts us." Kelly also later explained, "these kinds of regulatory burdens will put a chill on the types of funds that do work like CHB," characterizing the exemption (for which CHB is not eligible) as "one more barrier that smaller PE firms face."

Roundtable participants also devoted attention to the operational burdens imposed by the venture capital exemption. Rand Lewis and Steve Halstedt of Centennial Ventures noted that, if a firm wishes to avoid IAA registration, the venture capital exemption imposes operational burdens. Reflecting on certain deal structures—especially consolidations—used by Centennial Ventures over its history, Halstedt remarked that the definition would limit the type of deals that a VC firm could use to its advantage. Recalling a deal from the 1980s in which Centennial used leverage to buy dispatch radio companies at a purchase price of five or six times cash flow, Halstedt noted, "under [the venture capital exemption], that [deal] would not have qualified as a VC investment."[34] Halstedt's comment highlights the importance of leverage in determining whether a fund meets the definition of venture capital fund. The prohibition on leverage applies at two levels: at the fund level[35] and at the portfolio company level.[36] Further remarking on the

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http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C3813%5CSEC-Adopts-Rules-Implementing-Dodd-Frank.pdf.

[31] The exemption is not mandatory (a firm that qualifies as exempt can still choose to register). DAVIS POLK & WARDWELL, *supra* note 8.

[32] *See* SEC. & EXCH. COMM'N, *Form ADV: General Instructions*, p. 3, available at http://www.sec.gov/about/forms/formadv-instructions.pdf.

[33] *Id*.

[34] For a description of consolidations, *see*, *e.g.*, Robert Armstrong, *When Consolidation Fosters Innovation Among Start-Ups*, VENTURE CAPITAL DISPATCH, September 29, 2010, http://blogs.wsj.com/venturecapital/2010/09/29/when-consolidation-fosters-innovation-among-start-ups/. ("Big IT companies buy their smaller peers to ward off competition. Paradoxically, the strategy can give innovative young companies a foothold in the market. For entrepreneurs in enterprise IT and their venture capital backers, this phenomenon should provide inspiration. For M&A strategists at the market leaders, it's a warning.")

[35] Under rule 203(l)-1, a venture capital fund is a private fund that does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15 percent of the fund's capital contributions and uncalled

limitations imposed by the leverage prohibition, Halstedt observed, "all VC investments made in technology companies that grow organically as opposed to a buy/acquisition model have used some bank financing. I suspect that [as a consequence of the exemption] VC's use of leverage will come to a screeching halt." Bob McKenzie, Board Member of Crown Castle International, echoed this concern, questioning whether the leverage prohibition will "change the appetite that VCs have for certain types of investments" and remarking, "recurring revenue, subscriber businesses can attract debt. Does [the leverage prohibition] make it harder to build those kinds of businesses if VCs stay away?" Jason Mendelson suggested that there may be less concern than McKenzie fears, remarking that "VCs don't do that much debt; the company would go to a venture bank for it."

Halstedt summarized his view by acknowledging that even if the exemption "in large measure got it right," it dramatically reduces VC flexibility.[37] Mendelson reminded the Roundtable that "none of this means that a VC can't do an investment it wants, it just means that the VC has to suck it up and do more paperwork" required for IAA registration. Mendelson hastened to add, however, that in terms of the kind of information that firms are required to divulge, "even the exemption form is heinous." Tad Kelly voiced concern about the challenge of keeping information current. Brad Feld was blunt: the venture capital exemption just "adds another layer of bureaucracy."

Not all Roundtable participants were as animated about the venture capital exemption having a substantial impact on firms. Ken Fugate offered a terse assessment of the impact of the exemption: "I don't foresee a change in practices." George Hagerty, Partner at Hogan Lovells, concurred, expressing skepticism about any significant chilling effect on investments or fund behavior. Beau Stark, Partner at Gibson Dunn & Crutcher, was more circumspect about the

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committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days. Release, *supra* note 18 at 55.

[36] Rule 203(l)-1 defines a qualifying portfolio company for purposes of the exemption as one that does not borrow or issue debt obligations in connection with the venture capital fund's investment in the company and distribute to the fund the proceeds of such borrowing or issuance in exchange for the fund's investment. Release, *supra* note 18 at 41.

[37] Although not expressly discussed at the Roundtable, another potential constraint on investing flexibility is the SEC's view that Congress did not intend the venture capital exemption to apply to venture capital funds of funds. Release, *supra* note 18 at 49. A fund may disregard a wholly owned intermediate holding company formed solely for tax, legal or regulatory reasons to hold the fund's investment in a qualifying portfolio company (Release, *supra* note 18 at 51-2), but a VC fund of funds is not permitted. One issue that arises from this is that two VC funds might not be able to syndicate and use a subsidiary to own the portfolio company because the holding company would no longer be "wholly owned." Thus, this could be interpreted to mean that all syndicated investments will have to be directly into the portfolio company and not through a subsidiary. Credit to Charles Sommers for this observation.

exemption's impact on firms, remarking, "the answer to the question will be known soon; [but] if [registration] is much of a constraint on VC activity, then you will see bigger shops set up a special purpose [sidecar] fund with a registered adviser in charge of that fund."[38] Stark further observed that, at least for larger funds with more than $750 million under management, having a registered adviser is not particularly burdensome.

Although consensus was not quite reached among participants about the magnitude of the exemption's impact on firms, discussion of the topic also spurred more lively debate about how private equity and venture capital differ.

III. Differences Between Venture Capital and Private Equity

The most animated portion of the Roundtable centered on the differences—both technical and cultural—between private equity and venture capital. The PE/VC distinction implicates several interrelated features: public perception, leverage and fund operations more generally, attitudes towards regulation, and fund/investment size. Regarding (misguided) public perception and fund/investment size, Roundtable participants were in general agreement that private equity and venture capital exist on a spectrum rather than as binary categories. In terms of leverage and attitudes towards regulation, however, many participants (excepting a stronger view or two) saw a starker contrast, with private equity regarded as both distinctly more leverage-friendly and regulation-insensitive.

Public perception and stereotypes about the PE/VC distinction informed the Roundtable debate on the topic. Although not expressly emphasized in Roundtable discussion, coverage of the Silver Lake/Skype deal[39] illuminates contrasting visions of private equity and venture capital. Steven Davidoff has written of the contrasting perception as emblemized in the deal: "Venture capital is viewed as a creative industry, while the world considers private equity as finance,

[38] "An SPV, or a special purpose entity (SPE), is a legal entity created by a firm...by transferring assets to the SPV, to carry out some specific purpose or circumscribed activity, or a series of such transactions. SPVs have no purpose other than the transaction(s) for which they were created. . . ." Gary Gorton & Nicholas S. Souleles, *Special Purpose Vehicles and Securitization*, September 2005.

[39] When Silver Lake, a private equity firm, agreed to sell Skype to Microsoft, it came to light that "Silver Lake structured its options program for Skype so that...former Skype employees would not share in the windfall. The former employees [would] receive nothing." Initial coverage of the deal suggested that Silver Lake's structuring of the options was "contrary to Silicon Valley convention" and implicated a larger culture clash between private equity, where "money triumphs," and more entrepreneur-friendly venture capital. *See* Davidoff, *supra* note 14. *See also* Steven M. Davidoff, *Skype Not Alone When It Comes to Option Terms*, DEALBOOK, July 6, 2011, http://dealbook.nytimes.com/2011/07/06/skype-not-alone-when-it-comes-to-option-terms/.

money men who do not create."[40] Several Roundtable attendees sought to challenge the assumption underlying the ostensible culture clash, questioning the trope of "VC is good, PE is bad." As Beau Stark observed, "if there is a typical VC and private equity guy in the room, they can [easily] tell the difference between each other, but if you abstract it a bit and talk about their role in the economy or role in capital allocation, there are more similarities than differences." Ken Fugate also opined that the lines are blurred. He noted, "there are lots of different VC firms at different stages. VC firms in expansion-stage or late-stage companies tend to look more like PE firms; they face a different type of risk and want a certain revenue." Beau Stark observed that even if some of the differences between PE and VC might be pronounced in some instances, those differences do not have anything to do with what Dodd-Frank addresses in the venture capital exemption. Stark further clarified, "what Dodd-Frank misses is that PE does nearly everything in the VC definition, just not all the time."

Tad Kelly offered a more colorful challenge of the same trope: "When people think 'PE' they think Steve Schwarzmann's birthday party,[41] when they think 'VC' they think Google.[42] But those are extreme examples...the distinction is totally artificial." George Hagerty also questioned private equity's negative image, asserting, "some people think that 'LBO' is pejorative;[43] I don't see it that way; PE firms are using leverage judiciously." Beau Stark supported Hagerty's view, positing, "if PE as an industry relied only on highly leveraged LBOs, it would go out of business." Steve Halstedt offered a more robust view of private equity in general and the flaws in rule 203(l)-1 in particular: "private equity makes companies more effective and efficient, which is great for the economy; this rule is ridiculous and won't help America create jobs and won't help build the economy."

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[40] Davidoff, *supra* note 14.

[41] Martin T. Sosnoff, *The $3 Billion Birthday Party*, FORBES, June 21, 2007, http://www.forbes.com/2007/06/21/sosnoff-blackstone-ipo-oped-cx_mts_0621sosnoff.html.

[42] *See*, *e.g.*, *Creative tension*, ECONOMIST, September 17, 2009, http://www.economist.com/node/14460051. "Few companies are as creative as Google, which serves up innovations almost as fast as its popular search-engine serves up results."

[43] A leveraged buyout ("LBO") is "the acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. Often, the assets of the company being acquired are used as collateral for the loans in addition to the assets of the acquiring company. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital." *Leveraged Buyout – LBO*, INVESTOPEDIA, http://www.investopedia.com/terms/l/leveragedbuyout.asp (last visited June 28, 2012). LBOs came to public notoriety in the aftermath of "the mother of all corporate-takeover battles," when PE firm KKR acquired RJR Nabisco for $25 billion in 1988. The book *Barbarians at the Gate*, by Bryan Burrough and John Helyar, chronicled the deal and led to the (arguably pejorative) linguistic practice of calling private equity firms "barbarians." *See Barbarians at the Gate 2.0*, ECONOMIST, October 28, 2008, http://www.economist.com/node/12499201.

Taking a broader view, Professor Chris Leach observed that some of the public perception about private equity stems from its "legacy reputation." During the LBO craze in the 1980s, Leach explained, there was not a notion that private equity created jobs; private equity firms were "barbarians at the gate."[44] With venture capital, on the other hand, "there has never been doubt that VCs create jobs because they start at zero."[45] Josh Widoff, Managing Director of PE firm Black Creek Group, agreed with Leach, saying, "lines have been drawn on value judgments about how people go about making money." Justin Ishbia, Managing Partner at Shore Capital Partners, maintained that even if PE's reputational legacy persists, "it now is different from what it was in the 1980s; levering seven or eight times over EBITDA or dividend recapitalizations is not the model." Brad Feld was quick to retort, however, that a dividend recap of 100% equity[46] is "exactly what barbarians do."[47] On the topic of dividend recaps, Beau Stark asked whether they are especially pernicious, asserting that a dividend recap "puts discipline into the process," and suggesting that a dividend recap does not undermine the "overall value that a company brings to society."[48]

Discussion of the differences between PE and VC was not limited to invoking shorthand criticisms based on public perception. One well-regarded lawyer who was unable to attend the Roundtable discussion commented in email correspondence that, in the lower middle private equity market (fund size of $250 million to $1 billion), the stereotypical view of the culture clash

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[44] *See* ECONOMIST, *supra* note 43. Beau Stark offered a sharp riposte to such a view: "you cannot characterize PE as lurking for ways to fire people."

[45] Chris Leach also proffered that the venture capital fund exemption is "a political subsidy for non-reporting based on the sentiment that 'VCs create jobs.'"

[46] A dividend recapitalization is when "a company incurs a new debt in order to pay a special dividend to private investors or shareholders. This usually involves a company owned by a private investment firm, which can authorize a dividend recapitalization as an alternative to selling its equity stake in the company." *Dividend Recapitalization*, INVESTOPEDIA, http://www.investopedia.com/terms/d/dividendrecap.asp#axzz1vLo7gdGV (last visited June 28, 2012).

[47] *See*, *e.g.*, Dan Primack, *Obama and private equity: Friends or foes?*, MONEY.CNN.COM, March 28, 2012, http://finance.fortune.cnn.com/2012/03/28/private-equity-dividend-recapitalization/. The private equity industry's "most dangerous enemy, however, is not in the White House. It's in the mirror, due to private equity's pervasive use of dividend recapitalization—a noxious financial strategy that perverts the industry's mission and threatens its future ability to raise capital."

[48] *See also* David Toll, *In Defense of "Greedy, Parasitic Transactions"*, PRIVATEMARKETS.THOMSONREUTERS.COM (subscription required), March 15, 2012. "Dividend recaps, in which companies borrow money to pay their owners a dividend, are usually good for lenders. They're good for sponsors and their investors—foundations, endowments, public pensions etc. They're often good for management teams, assuming those management teams like their sponsors and have equity in their companies. And finally, they're no worse for companies and rank-and-file employees than your run-of-the-mill leveraged buyout."

pitting ruthless PE financiers against entrepreneur-friendly VCs is, in fact, "quite the opposite." The lawyer's observations lend a provocative alternative view of the PE/VC culture clash:

> [V]enture/crossover funds sometimes step into my PE growth equity/buyout deals and I am always shocked at how rigid their structures are and how investor-friendly the terms are (participating preferred/common equity, all rights in favor of investors (preemptive rights, co-sale, registration, etc.)). Most of our PE fund clients invest their equity in the same class as the founders or at least non-participating convertible preferred so there is not an economic distinction between them.

The lawyer further opined that PE investors frequently use creative structures (LLC holding companies instead of the C corporation) to give "the cheapest, most management friendly equity available—profits interests."[49] In contrast to the use of stock/options-based incentive arrangements typically seen in venture capital deals, the use of profits interests for management in certain private equity deals can create especially tax-advantaged incentives.[50] "The sale of a profits interest always results in capital gain, is not subject to any holding period requirements beyond the one-year long-term capital gain holding period and does not require the holder to put capital at risk."[51] In private follow up discussion, two Colorado-based private equity lawyers noted that private equity's concern for management might vary according to size of the private equity firm. The lawyers suggested that whereas the biggest PE firms might not be as management friendly as are venture capitalists because those PE firms have such strong brand strength, middle market PE firms can be more management friendly.

Discussion also compared the operational strategies of PE and VC. Beau Stark remarked that both PE and VC closely focus on company management, and that "both industries look for ways to improve company operations and they do it at different stages of the company's growth/size." In response to the suggestion that PE and VC have similar attitudes regarding "company management," Brad Feld disagreed, insisting, "I don't ever think about people running companies as managers. I think of them as entrepreneurs." Even when Foundry Group owns 60% of a portfolio company, Feld explained, it still thinks of itself as backing

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[49] Email on file with author; *see also The Use of LLC Profits Interests as Management Incentives in Buyouts*, GOODWIN PROCTER (February 2007), http://www.goodwinprocter.com/~/media/Files/Publications/Newsletters/Private%20Equity%20Update/2007/The_Use_of_LLC_Profits_Interests_as_Management_Incentives_in_Buyouts.ashx.

[50] *See id*.

[51] *See id*. *but see* "However, the portfolio company does not receive a deduction in connection with the grant or sale of a profits interest."

entrepreneurs. Such a distinction in whether a firm backs "managers" or "entrepreneurs" stands out to Feld as emblematic of a cultural difference between PE and VC. Lending an on-the-ground perspective about the intersection of private equity and venture capital, Carla Donelson, Founder of Verio, spoke of a proposed deal in which both a VC firm and a PE firm were considering co-investing in the same deal. Not only were there valuation issues around the first company that the investors would a3cquire, Donelson noted, there also were structural issues. "The biggest issue was compensation of the company's management team; the VC firm looked at management as owners who were equally invested in a company growth opportunity, whereas the private equity firm viewed company management as a commodity." Bob McKenzie, countered, however, recalling transactions into which his company entered with VC and PE investors alike. "PE and VC can coexist," McKenzie stated.

Jason Mendelson raised a provocative question about the importance of reputational constraints between the two industries. In venture capital, Mendelson explained, "it is a small world with many repeat entrepreneurs; everyone in Boulder would know if Foundry Group did something bad [to an entrepreneur]." Justin Ishbia proffered that reputation is equally important in the private equity industry, explaining of Chicago's private equity scene, "everyone knows everyone's deals. Reputation is all you have." Ishbia conceded that even if rank and file employees of a large, private equity-controlled company might not be as sensitive to the reputation of a PE firm as rank and file employees would be to the reputation a venture capital-controlled startup, reputation is still very important with respect to a private equity firm's capacity to recruit and work with company management and banks. Brad Feld took a different tack regarding reputational constraint, suggesting that when a young company fails in the venture capital world, "there is often a lot of preservation of relationships into a new company." In the case of company failure in the PE context, however, "the negative sentiment about investors is more significant." Lee Reichert offered that if "management is rolling over as part of a recapitalization, the reputation of the PE firm really matters."

Roundtable participants also discussed differing attitudes towards regulation as an illustration of the culture clash. Jason Mendelson[52] described the differing approach that the VC and PE industries took towards Dodd-Frank. Mendelson explained that the cultural differences

[52] Mendelson is a Board Member of the National Venture Capital Association. http://foundrygroup.com/team/jasonMendelson.php

between PE and VC played out in how each industry approached federal regulation under Dodd-Frank. The venture capital industry was "coordinated and organized," whereas private equity representatives were less coordinated. Recalling the differing way each industry addressed Dodd-Frank, Mendelson noted, "all the VCs in Washington D.C. showed up in button down shirts and flew commercial; the PE people showed up in suits from their private jets." Steven Davidoff has written on the same phenomenon, remarking that, compared to private equity, venture capital has a better public image.[53] As Davidoff has written, "No one talks of taxing venture capital billionaires they way they do about private equity barons."[54] Another view, however, is that private equity saved its efforts for a future battle. Beau Stark offered another explanation as to why private equity firms did not appear to have spent much political capital on fighting Dodd-Frank: they are "saving their powder for fighting carried interest."[55] In follow up discussion, Stark further suggested that the largest PE funds "don't care that much" about the venture capital exemption because they "are not that that sensitive about having to register; many are thinking of going public anyway." Tad Kelly shared anecdotal evidence of this attitude: "the only time TPG wants to talk to CHB is when it's about taxing carried interest, not anything else."

Roundtable discussion was starker regarding the role of leverage in distinguishing private equity from venture capital. Jason Mendelson remarked succinctly that the use of leverage in fact is "a highly distinguishing factor between PE and VC." Ken Fugate concurred, noting, "bankers see a clear line between PE and VC, specifically regarding the strategy" that each type of investor applies towards their investments. In Fugate's words, there is a "big difference, from a credit perspective," how VC and PE use leverage: PE keeps a fraction of the equity at stake in an investment that VC does. Brad Feld similarly perceives a meaningful difference between PE and VC along the lines of leverage, calling it "a crossover point" and positing that insofar as a firm like Centennial Ventures (widely regarded as a pioneer of Colorado's venture capital industry) does leveraged consolidations, it "looks more like private equity." Although Feld conceded that there might be an "overlap zone" where a firm uses leverage but could still be a VC firm, he was quick to note that the overlap is not especially big (i.e., leverage is still useful in

[53] Davidoff, *supra* note 14.
[54] *Id*.
[55] *See*, *e.g.*, Lowenstein, *supra* note 5. *See also* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 NYU L. Rev. 1 (2008).

separating venture capital from private equity). Feld offered a succinct view, giving an example of a company with a capital structure of 25% equity and 75% debt: "from the venture side, it wouldn't play that way."

Roundtable discussion also gave credence to the view that fund/investment size is an important part in understanding the PE/VC distinction as a blurred continuum. Tad Kelly stressed (and many Roundtable participants agreed) that there is a spectrum of investment and fund size across the private equity industry, with lower middle market private equity funds in particular occupying a gray area between clearer delineations of "private equity" and "venture capital." Kelly noted that, in terms of capital raised from limited partners, CHB is the "same size as the average VC fund." Reflecting on the size issue more broadly, Kelly suggested that there is a continuum in which it is hard to make a binary judgment as to whether a firm is a private equity firm or venture capital firm. As Kelly stated, "this distinction is less stark than is being made out to be and there is a continuum; [even if] it is a small number of companies that fit that gray area." Prompted by a question about why the private equity versus venture capital debate exists in the first place, Kelly asserted that fund/investment size is an important factor. "The smaller the [investment], the more it has to be treated as a VC investment, not a financial transaction where time and cash flow pays down debt," Kelly noted.

The Roundtable's overall sentiment regarding the PE/VC distinction, then, was a complex assessment. Virtually all participants may have agreed that the perception of a sharp culture clash ignores the many nuanced shades of PE and VC, but the issues of leverage and how each industry approached regulation indeed suggest that some differences are more pronounced. Consensus was more readily found, however, in the Roundtable's consideration of the next major regulatory challenges implicating the PE/VC distinction.

IV. The Next Big Thing: Systemic Risk

In considering "the next big thing," the Roundtable generally agreed that the next major regulatory challenge implicating the PE/VC distinction will be legislation concerned with systemic risk,[56] such as the Volcker rule.[57] Roundtable participants were equally, if not more,

[56] Steven Schwarcz has argued that systemic risk is "the risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or

adamant that neither private equity nor venture capital, however defined or distinguished from one another, meaningfully pose systemic risk.

Erik Gerding, Associate Professor of Law at the University of Colorado, teed up systemic risk as the next regulatory challenge implicating the PE/VC distinction. Gerding identified the Volcker rule as one example of legislation concerned with systemic risk. As Gerding observed, "VCs funds are strenuously arguing in comments to Volcker rule that investments in VC funds should be exempt from Volcker rule prohibitions on what investments banks may make."[58] Indeed, in public comments to the SEC, the National Venture Capital Association has argued for Volcker Rule exemption because venture capital funds "do not pose systemic, safety or soundness risks to the United States financial markets or banking industry."[59] Although there was little Roundtable discussion about the specifics of the Volcker rule, the Roundtable more vigorously considered the PE/VC distinction in the context of systemic risk writ large. Gerding emphasized systemic risk as the next challenge because, in his view, Rule 203(l)-1 appears to address investor protection more so than it addresses systemic risk. Gerding argued that the Volcker rule is a regulation more geared towards systemic risk than Rule 203(l)-1. Gerding asserted that systemic risk presents two major concerns: liquidity and leverage. As Gerding summarized liquidity, when investors invest in either private equity and venture capital they know they are making an illiquid investment. In turn, both private equity and venture capital firms are themselves making illiquid investments. Regarding leverage, Gerding echoed the leverage discussion referenced above in Section III of this Report: leverage is more important in making a regulatory distinction between PE and VC. "If a bank invests in an LBO fund,"

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decreases in its availability, often evidenced by substantial financial-market price volatility. Steven L. Schwarcz, *Systemic Risk*, Duke Law School Legal Studies, Research Paper No. 163, March 2008.

[57] The Volcker rule would allow the imposition of capital requirements and quantitative limits on proprietary trading or fund activities. *The Volcker Rule*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM, http://www.skadden.com/newsletters/FSR_The_Volcker_Rule.pdf.

[58] *See*, *e.g*., "Silicon Valley Bank is warning that the Volcker rule could hit the venture capital community it serves and deal a blow to startup companies critical to innovation and job creation." Dave Clarke, *Silicon Valley calls the help desk on Volcker rule*, REUTERS, January 12, 2012, http://www.reuters.com/article/2012/01/12/us-financial-regulation-volcker-idUSTRE80B1QB20120112.

[59] *See, e.g*., Letter from National Venture Capital Association to Department of Treasury et al. (Feb. 3, 2012), http://www.federalreserve.gov/SECRS/2012/March/20120315/R-1432/R-1432_020312_88720_465826131733_1.pdf. "We encourage the Agencies to further refine their definition of a "covered fund" to prevent venture capital funds from being swept into the Volcker Rule which, by statute, applies only to hedge funds and private equity funds."

Gerding claimed, “there is a strong concern that if the LBO fund goes south as credit dries up, banks will start deleveraging.”[60]

Roundtable discussion also identified an important discrepancy about the venture capital exemption itself: the interplay of investor protection (i.e., protect investors from opportunistic behavior by unscrupulous advisors) and systemic risk (i.e., prevent systemic financial collapse). Roundtable participants agreed that little of Rule 203(l)-1 actually mitigates systemic risk. If anything, in their view, the exemption pertains to investor protection. Yet despite the exemption having qualities more akin to investor protection, the Roundtable emphasized that the tenor and emphasis of Capitol Hill debates, lobbying efforts, and rulemaking itself suggest that systemic risk was the primary federal concern in creating Rule 203(l)-1.[61] The SEC itself spoke of systemic risk regarding Rule 203(l)-1, claiming, “the proposed definition of venture capital fund was designed to distinguish venture capital funds from other types of private funds, such as hedge funds and private equity funds, and to address concerns expressed by Congress regarding the potential for systemic risk.”[62] Jason Mendelson spoke from his experience in Capitol Hill lobbying efforts around Dodd-Frank, remarking that Rule 203(l)-1 “was not about investor protection, it was about systemic risk.” Mendelson further remarked, “Congress looked at the dollar amounts in individual PE deals and saw systemic risk.”

Of course, whatever the ultimate regulatory classification of Rule 203(l)-1, Roundtable participants agreed with Josh Widoff’s point that it “doesn’t achieve systemic risk protection or investor protection.” Tad Kelly also criticized whatever might come of the Volcker rule, opining that “as soon as the final text of the Volcker rule comes out, there will be five or six big investment banks who sell products to depository banks splitting the difference between debt and equity to come out just on the right side of having too much leverage.” Steve Halstedt offered a critical encomium to the Roundtable’s discussion of the future of financial regulation. “The

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[60] Deleveraging is “the unwinding of debt. Companies use leveraging (i.e., borrowing) to accelerate their growth or return, however, when a company is concerned about defaulting on its obligations or concerned about rampant losses, it can use deleveraging to lower its risk of default and mitigate its losses...Deleveraging can have serious financial consequences when a company tries to unwind assets that are illiquid. In this case, deleveraging may mean selling assets at a relatively steep discount. As a result, deleveraging may lead to downward pressure on security and asset prices. . . .” *Deleveraging*, INVESTOR GLOSSARY, http://www.investorglossary.com/deleveraging.htm (last visited June 28, 2012).

[61] Evincing Roundtable complaint about Congress not understanding the distinction between systemic risk and investor protection, the venture capital fund exemption implicates registration under the IAA, which the SEC proclaims is designed to require investment advisors to “conform to regulations designed to protect investors.” *See* SEC. & EXCH. COMM’N, *supra* note 17.

[62] Release, *supra* note 18 at 10.

mentality of regulators is to come up with a rule for everything. The mentality of VCs and PE people is to break all the rules. Regulators will come up with new rules, but I worry about regulatory creep."

Conclusion

The PE/VC distinction implicates a variety of issues, several of which are important touch points for future regulation and investment activity. Roundtable discussion and research suggests that (a) Dodd-Frank will impose costs on both PE and VC firms, but only will change how a small subset of firms actually operates; (b) the PE/VC distinction is complex—the use of leverage and certain operational differences suggest grounds for delineation, but differences between PE and VC largely exist on a spectrum; and (c) the next major regulatory challenge implicating the PE/VC distinction will be legislation concerned with systemic risk (such as the Volcker rule). That Roundtable participants strongly feel that neither PE nor VC, however defined or distinguished from one another, meaningfully pose systemic risk, only underscores the high stakes of financial regulation.

Appendix A:
Roundtable Participants

Brad Bernthal (Moderator)	Associate Professor, Colorado Law School
David Cline	J.D., Class of 2012, Colorado Law School
Carla Donelson	Founder, Verio
Brad Feld	Managing Director, Foundry Group
Ken Fugate	Founder and SVP, Square 1 Bank
Erik Gerding	Associate Professor, Colorado Law School
George Hagerty	Partner, Hogan Lovells
Steve Halstedt	Managing Director, Centennial Ventures
John Howard	Board Member, General Growth Properties SPEs
Justin Ishbia	Managing Partner, Shore Capital Partners
Jamie Jackson	J.D. Candidate 2013, Colorado Law School
Tad Kelly	Managing Partner, CHB Capital Partners
Mark Kurtenbach	Associate, Hogan Lovells
Chris Leach	Professor of Finance & Entrepreneurship, CU Leeds
Rand Lewis	Managing Director, Centennial Ventures
Andy Livadariu	Director, Green, Manning & Bunch
Dominic Lloyd	Partner, Baker Hostetler
Bob McKenzie	Board Member, Crown Castle International
Jason Mendelson	Managing Director, Foundry Group
Jessica Morgan	J.D., Class of 2012, Colorado Law School
James Muchmore	Partner, Messner & Reeves
Robert Novick	Managing Partner, enVision
Lee Reichert	General Counsel, Molson Coors
Matt Reisman	M.B.A., Class of 2012, CU Leeds Business School
Bill Roberts	Partner, Roberts & Olivia, LLC
Andrew Schwartz	Associate Professor, Colorado Law School
Beau Stark	Partner, Gibson Dunn & Crutcher
Charles Sommers	Attorney-Adviser, SEC, Division of Trading and Markets
Danielle Town	LLM, Class of 2012, Colorado Law School
Josh Widoff	Managing Director, Black Creek Group
Dan Weiner	EVP Marketing & Products, Thought Equity Motion
Elizabeth Weiner	Co-Founder and Managing Principal at KAP Group
Phil Weiser	Dean, Colorado Law School
Mark Wiranowski	J.D., Class of 2012, Colorado Law School
Michael Zeisser	Senior Vice President, Liberty Media