Testimony of Sherrill Neff, Quaker BioVentures
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Introduction:

Members of the Committee, good morning. My name is Sherrill Neff and I am a partner with the venture capital firm Quaker BioVentures located in Philadelphia, Pennsylvania. Thank you for the opportunity to testify today on a very important issue for the venture capital industry: the role of defined benefit pension plans as a critical source of capital formation for both our industry and the start-up companies in which we invest.

By way of background, Quaker BioVentures is a venture capital firm investing in life science companies, including biopharmaceuticals, medical devices, human diagnostics, specialty pharmaceuticals, and healthcare services. My partners and I invest in companies at all stages of development, from the earliest stage of businesses to later pre-public companies. The firm was formed in 2003 and is currently investing Quaker BioVentures II, a $420M fund raised in 2007. In total, Quaker BioVentures manages over $700M in committed capital of which approximately 75% percent comes from large public and private defined benefit plans. Our investors include 10 public pension funds from six different states and major corporate pension funds. Since 2003, we have invested in 28 life sciences companies, most of which were start-up or early stage companies, and all of which are pursuing important and innovative therapies, devices, diagnostics or other healthcare services.

My firm is also a member of the National Venture Capital Association (NVCA). The NVCA represents more than 480 venture capital firms in the United States and advocates for policies and legislation that are favorable to American innovation and entrepreneurship. In 2007 alone, venture capitalists invested approximately $30 billion into small, high-risk, emerging growth companies in areas such as life sciences, information technology, homeland security, and clean technology. The goal of our industry is simple – to bring the most innovative new products and services to market in the most efficient manner, while maximizing returns for our institutional investors.

Today I would like to explain how the venture capital industry raises and invests money, the economic implications of this investment, and the importance of defined benefit pension plans in that equation.

Venture Capital Fund Structure

Venture capital is a relatively small, but extremely unique sub-sector of what many institutional investors refer to as alternative assets. Venture capital funds are set up as limited partnerships in which sophisticated institutional investors or limited partners ("LPs") provide capital to a fund managed by a group of venture capitalists or general partners, ("GPs"). The GPs invest this capital along with their own in high risk and often high tech private start-up companies that demonstrate a tremendous promise for growth over the long term. The typical investment horizon for a venture-backed company is 5 to 10 years, often longer and rarely less. Once the company has grown to a viable size, it either goes public or becomes acquired by a strategic buyer, hopefully at a significant investment return to the venture capital fund, the entrepreneur, and the LPs. Given the high risk nature of the investment, it is understood that many venture-backed companies ultimately fail. However, those that succeed return top dollars to investors and create jobs and revenues for the US economy. Yet, it is not an investment for the faint at heart.

For that reason venture capital LPs are highly sophisticated investors who understand the value of "patient capital". They recognize that their investment will not be liquid for some time but they are willing to make that commitment for the benefit of higher returns. The life of a venture capital fund is typically set at 10 years but in reality, it is often much longer – 15 to 17 years – until the last investment is harvested and distributions are made. Yet, on a pooled basis over the long-term, the venture capital asset class has outperformed the public markets for many years. The ten year performance for all venture funds through 12/31/2007 was 18.3 % as opposed to NASDAQ which registered 5.3% and the S&P 500 which was 4.2%. Source: Thomson Reuters/NVCA.

Approximately 90 % of venture capital commitments come from institutional investors – defined benefit pension funds, insurance companies, university endowments, corporations and foundations. The small percentage of individual investors who become venture fund limited partners are designated as high net worth and have the financial resources and staying power to commit large amounts of capital to illiquid investments for periods of time that, as I explained, can exceed a decade. All of these investors have the ability to obtain significant independent financial advice in order to evaluate potential investments. For this reason, under applicable securities laws, venture capital limited partnerships are not required to be registered with the Securities and Exchange Commission.

The relationship between the GPs and the LPs is extremely important in the venture capital life cycle. GPs spend a considerable amount of their time and effort raising the fund which they intend to invest in emerging growth companies. The fundraising process consists of preparing offering materials, identifying and meeting with appropriate and compatible investors (LPs) and their professional advisors, responding to LP due diligence requests, and negotiating the terms of their commitment. It is not unusual for this fundraising process to take a year or longer. However, once an institutional investor joins a fund as an LP, they are likely to invest in follow on funds if the relationship is a good one. Participation in the most successful funds is highly competitive. Funds will indeed turn away money from institutional investors once their target fund level is achieved.

The venture capital industry would not exist without the support of limited partners who provide the majority of the capital invested in the young businesses. In return, the general partners provide time, management expertise and experience in identifying and nurturing these companies so that they grow into viable and valuable businesses.

The Role of Defined Benefit Plans in the Venture Capital System

You have heard from the other witnesses today about many of the positive contributions that defined benefit plans offer their participants. I would like to address an attribute of the defined benefit plans that may be less well known: the role of defined benefit plans in the funding and growth of the venture capital industry and the entrepreneurial segment of the US economy.

Defined benefit pension plans have historically been a sizable and reliable pool of capital for venture fund formation and thereby for investment into the nation's emerging growth companies. The US venture capital industry would not be the economic engine it is today without the strong investment participation from defined benefit plans. Federal rules first permitted defined benefit plans to invest in venture capital in the 1980s.

In 1974, the Employment Retirement and Income Security Act (ERISA) was enacted to protect the pension and welfare benefit rights of workers and beneficiaries. Private pension plans had already been in existence for many years, but the passage of ERISA marked the growing importance of these private plans in the retirement income equation.

One of the critical regulations which was established for the first time by the federal government in ERISA concerned the investment of pension assets by those responsible for their control. The Department of Labor was given exclusive authority to issue regulations and rulings that define who is an ERISA fiduciary. Thus, in 1979 the Department of Labor issued its "prudence regulation" which interpreted ERISA as allowing pension plans to invest in young, smaller companies. This regulation provided managers of pension funds the ability to channel money into venture capital funds which they have done in increasing, yet reasonable amounts ever since.

As a direct result of the ERISA "prudent man rule" money from public and private pension funds began to flow into the venture capital space beginning in the 1980s. In 1980 private independent venture funds had just over $4 billion in capital under management. This rose to $18 billion in 1985, $28 billion in 1990, $41 billion in 1995, $225 billion in 2000, and $257 billion in 2007. Much of this growth is attributable to the success of venture capital investment and the receptivity of defined benefit plans to the high returns the asset class afforded them.

Yet the mix of limited partners is changing. Because many US based private pension plans have been converted from defined benefit plans to defined contribution plans over the past several years, we are seeing fewer private pension plans actively investing in venture. Filling that gap are LPs from <u>outside</u> the United States, including foreign public and private pension funds who are becoming increasingly interested in investing in US based venture capital funds.

Yet US public pension plans continue to be critical and reliable sources of capital for US venture funds. The vast majority of state pension funds and many local public pension funds invest a small portion of their assets in private equity because they understand that, while long-term and sometimes riskier than bonds and stocks, venture capital can deliver returns that boost the overall financial position of the fund. Today all but a few states permit their public pension funds to invest a small amount of their assets into the venture capital asset class. States that have been long-time venture capital investors include California, Washington, Pennsylvania, and Wisconsin.

Most public entities invest only a small portion of their investible assets in private equity/alternative assets, often less than 5%, because of the potential risk and long term nature of the asset class. Thus, in exchange they expect to receive a return on investment that is much higher than traditional asset classes. Defined benefit plans usually diversify their commitments to alternative asset classes two ways: (1) by investing across different alternative asset sub-classes (real estate, buyout, private equity, venture capital and hedge funds; and (2) within each sub-class investing in a large number of different managers. As a result, the pension plan’s exposure to any one alternative asset class or to any one manager is very limited.

Venture capitalists who take defined benefit pension plans into their funds do so because these fund managers are long-term, patient investors who understand the nuances and risks of venture investing. Additionally, VCs have found defined benefit pension LPs to be knowledgeable, forthright and valuable investment partners over the length of the fund. With demand for participation in venture capital funds at an all time high, this trusted relationship helps guarantee a coveted spot for defined pension plans. However, should these plans convert to defined contribution plans, that spot will be forfeited to other institutional investors as the requirements for investment in the venture capital industry are not compatible with the characteristics of defined contribution plans.

The Economic Impact of Venture Capital Investment

When a defined benefit pension plan invests in a venture capital fund, it is not only creating higher returns for its pensioners, but it is also supporting one of our country's most important economic engines. Literally thousands of companies would not exist today were it not for the venture capital investment support they received early on. Federal Express, Staples, Outback Steakhouse and Starbucks are well known examples of traditional companies that were launched with venture backing. Cisco, Google, EBay, Yahoo and countless other technology companies were all, at one time, just ideas that needed start-up capital and guidance.

In the same vein, venture capital has been an important catalyst for innovation in the life sciences and a multitude of medical innovations would not have been possible without it. Genentech started with venture backing. So did Amgen, Genzyme and Medtronic. Over the last several decades, venture capitalists have partnered with scientists to build successful businesses and bring to market such drugs as Herceptin, an important part of our war on cancer and Integrilin, which significantly reduces blood clotting. Studies suggest that more than one out of three Americans will use a medical product or service generated by a venture- backed life sciences company.

According to the econometrics firm Global Insight, last year US based, venture-backed companies accounted for more than 10.4 million jobs and generated over $2.3 trillion in revenue. Nearly one out of every ten private sector jobs is at a company that was originally venture-backed. Almost 18% of US GDP comes from venture-backed companies.

Venture investors are constantly looking for the next "big thing" and these days, many of my colleagues are active in building alternative energy companies in what is called the "clean technology" industry, a sector which I'm sure we all agree will play a vital role in America's global competitiveness for years to come.

None of this value would have been possible without the active investment of public and private defined benefit pension funds. The relationship between the venture industry and defined benefit managers is a symbiotic one that creates high returns for the investors and the US economy. It represents a highly efficient use of capital that we assert should remain in the system. I can tell you unequivocally that most venture firms would prefer to ensure (1) that the jobs and technologies we fund be based here in the US, and also (2) that the returns we generate on our investments also be returned to American pension beneficiaries. That will continue to occur as long as the defined benefit plans are embraced as an important part of our overall retirement system.

Conclusion:

Thank you for the opportunity to weigh in on this important issue. We look forward to working with many of the large defined benefit pension managers for years to come. The support of these programs not only helps pension holders, but also creates jobs, generates revenues and fosters innovation for our country, contributing to a healthy US economy at both a micro and macro economic level.

I am happy to answer any questions.