Statement of Michael Brown
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Before the U.S. Congress Joint Economic Committee
"The Innovation Economy, Entrepreneurship, and Barriers to Capital Access"

July 12, 2018

Chairman Paulsen, Ranking Member Heinrich, and Members of the Committee, thank you for the opportunity to testify today on the important subject of capital formation for growth companies. My name is Michael Brown, I have been a venture capitalist for twenty years and am currently a General Partner at Battery Ventures. Battery is a venture capital (VC) firm that invests in and partners with growth companies in a broad range of industry areas. I am here in my capacity as a board member of the National Venture Capital Association.

Put simply, venture capital is long-term equity investment into growth companies. We generally either come in alongside or follow angel investors as the next growth financing step for startups. Most of the capital we invest is used on research and development, salaries and hiring, or other expansion activities at our portfolio companies.

But, venture capital is also about more than just investment. Successful VCs don't simply pick winners, we work alongside our portfolio companies to build startups into successful enterprises. We usually serve on the boards of directors of our portfolio companies. We provide advice and counsel, contacts, and do whatever we can to support the growth of our portfolio companies. We generally provide multiple rounds of financing as our companies hit certain growth milestones over a period of five to ten years, sometimes longer. The standard agreement to invest in a venture capital fund runs ten years with options for extensions, to provide some context of the time horizon for a VC fund.

There's an important distinction between startups and small businesses. Both start small, but while traditional small businesses are more likely to use debt for financing needs and stay somewhat small throughout their existence, startups generally use equity financing and their goal is growth into significant enterprises. To illustrate this point, recent research has shown venture capital invests in less than one percent of all new businesses in the U.S., but nearly half of all companies that have become public companies since 1979 have been backed by venture capital[1].

Encouraging investment in startups and centers of innovation across the country has a positive compounding effect that I have experienced first-hand. In 2009, I led a $70 million investment in a company in Indianapolis named ExactTarget. With our investment, Scott Dorsey, the founder and CEO, along with a talented management team was able to more than triple their investment in research and development and create an additional 1,500 jobs in the State of Indiana. As a result of the company's growth, ExactTarget went public in mid-2012, which was the largest IPO of a subscription software company ever in the U.S. Approximately a year later, the company was purchased by Salesforce for $2.7 billion and has continued to grow and add hundreds of jobs to the economy. More interestingly, many former ExactTarget employees are reinvesting the proceeds from the sale of the company into dozens of new startups with the help of Scott Dorsey and his venture studio called High Alpha. The strategy is to leverage the success of ExactTarget to create the next generation of great start-ups, resulting in a virtuous cycle of innovation over the decades to come.

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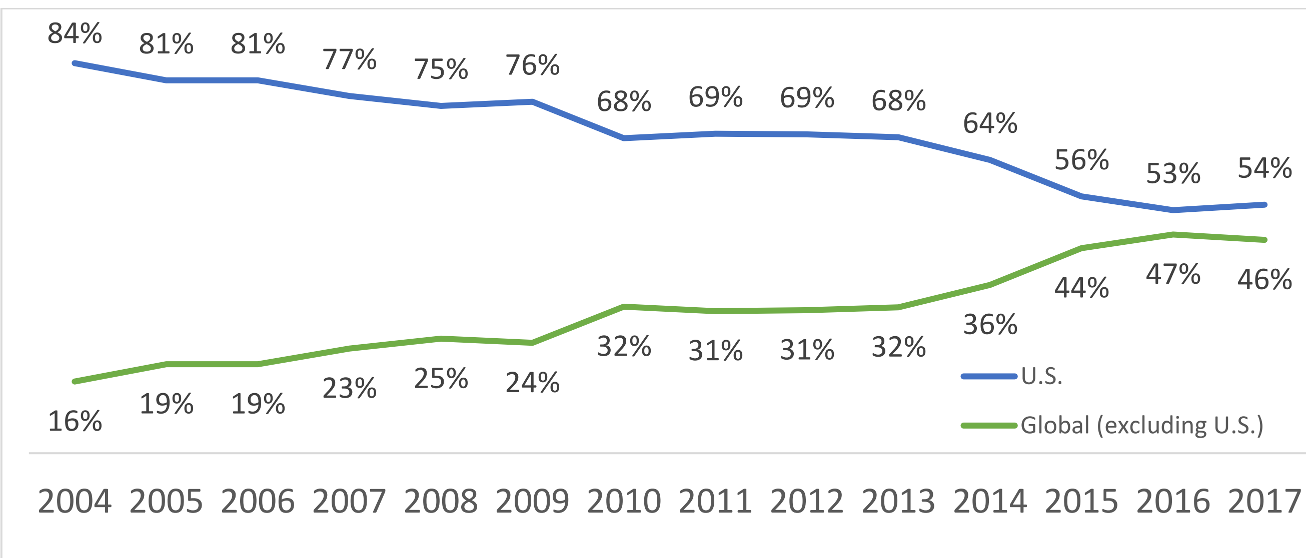
[1] "How Much Does Venture Capital Drive the U.S. Economy," Stanford Graduate School of Business (October 21, 2015), *available at* https://www.gsb.stanford.edu/insights/how-much-does-venture-capital-drive-us-economy.

Importance of Entrepreneurship Policy

The creation and growth of new companies is critical to American economic competitiveness. The U.S. invented the modern venture capital industry and has historically been the global leader in the modern era in innovation and entrepreneurship. As recently as the late 1990s, over 90 percent of global venture capital was invested in U.S. growth companies. Our country has benefited greatly from this leadership. A 2010 study from the Kauffman Foundation found that young startups, many venture-backed, were responsible for almost all the 25 million net new jobs created since 1977[2]. Companies such as Apple, Amazon, Alphabet (formerly Google), Amgen, and Genentech are a few examples of venture capital success stories which have become household names.

But that position has changed dramatically over the past several decades as global competition has increased, and last year just 54 percent of global venture capital was invested in American startups. Other countries have studied what we have done right and launched policy reforms to emulate and improve on our model. China is now the second most prominent destination for venture capital, and the European Union has seen some significant growth as well. In fact, last year seven out of the ten largest venture deals in the world took place in China, when eleven years before that ten of out of the ten largest deals took place in the U.S.[3]

U.S. VC Investment Dollars as % of Global Total



Source: NVCA 2018 Yearbook, Data Provided by Pitchbook

A healthy competition among countries to find cures for diseases and next generation technologies can certainly be positive for the world, but it's a competition where we should desire to win. We need commitment from American policymakers to do that.

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[2] "The Importance of Startups in Job Creation and Job Destruction," Kauffman Foundation Research Series: Firm Foundation and Economic Growth," (July 2010), available at http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2010/07/firm_formation_importance_of_startups.pdf.

[3] Pitchbook – NVCA data.

This is why the hearing you have called today is so critical to informing our public policy debate. In order to view this issue in its entirety, I strongly encourage Congress to look not just at policies that impact investment in entrepreneurship, which are important issues unto themselves, but also policies impacting participation in the entrepreneurial ecosystem. Founders, startup employees, VCs, and angel investors must all find the risk/return ratio worthwhile in order for our entrepreneurial ecosystem to flourish. We can have the most liquid startup investment model in the world, but if these investments produce disappointing returns or if tax policy depresses incentives for participation, investment in entrepreneurship will suffer.

I would also encourage Congress to think of the issue with two priorities in mind:

1. build global-scale companies and preserve America's leadership in the 21st century economy, and
2. expand venture capital and entrepreneurial activity to more areas of the country.

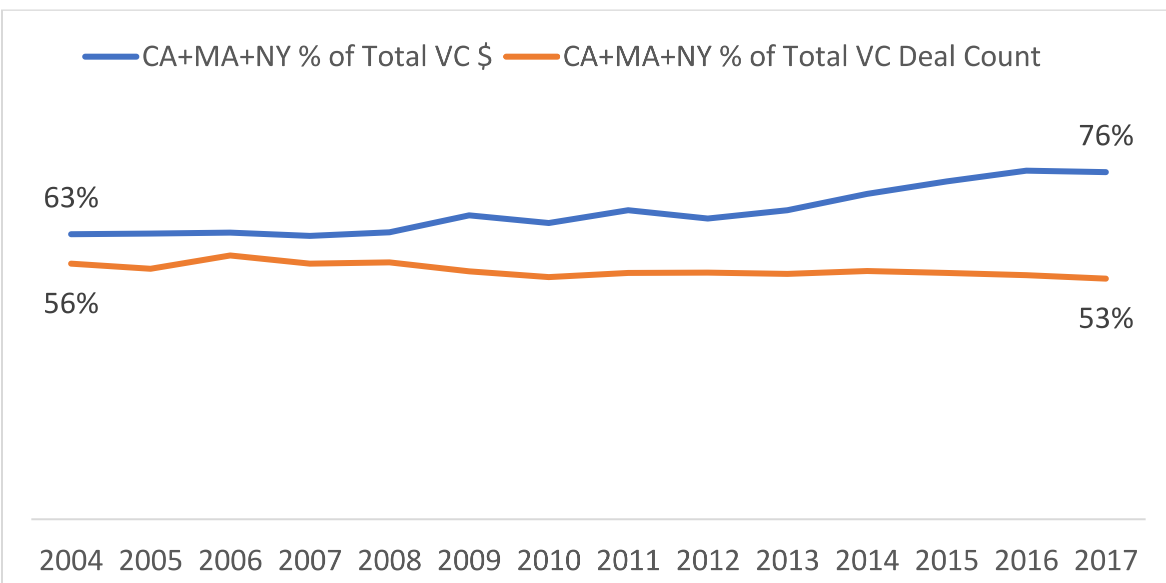
These priorities are certainly complimentary, and most of what I will discuss today will impact both, though some issues will have a more significant impact on one priority.

<u>Policies that Impact Investment in Entrepreneurship</u>

The venture capital industry serves as a sort of intermediary between the capital provided by institutional investors seeking higher-risk returns, such as pension funds, endowments, and foundations, and the startups seeking to use that capital for growth. VCs have a unique view of startup capital formation issues because we see both the perspective of having to ask for capital to invest in startups from our limited partners (LPs) and the investor perspective when we deploy that capital into companies.

While there is currently significant capital clustered in the three largest tech centers in the U.S.--California, Massachusetts, and New York--many other states have a shortage of access to venture capital financing. The good news is that the percentage of U.S. venture capital deals in states other than these three has increased over the last ten years, but at the same time, capital has concentrated further within those three large, coastal tech centers.

CA/MA/NY Venture Capital Investment Activity



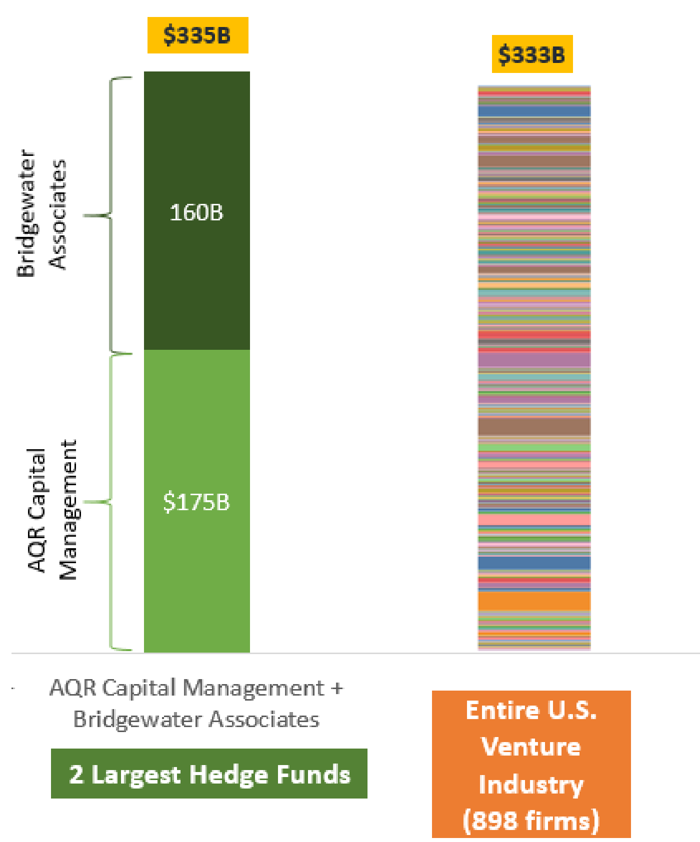
Source: NVCA 2018 Yearbook, Data Provided by Pitchbook

As Scott Dorsey is showing with his work at High Alpha Venture Studio, the most effective way to spread venture capital, and thus entrepreneurial activity, to more regions of the country is to increase the number of venture capital firms off the coasts. As I discussed earlier, venture capital tends to be a hands-on business. We want our portfolio companies in close proximity so we can communicate more frequently and effectively. We are partners with our companies, so ideally we are present at board meetings and other significant events. Encouraging the creation and growth of more local VC firms will A) provide more access to capital to companies in their backyards and B) give larger out of state VC funds contacts we can work with in finding and financing companies outside of our home regions.

Volcker Rule

One painless way to help seed new venture capital funds in emerging regions would be to exempt bank investment in venture capital funds from the covered funds prohibition of the Volcker Rule. Congress put this prohibition in place to prevent banks from circumventing Volcker Rule restrictions on proprietary trading that could create systemic risk simply by shifting it to a sponsored private fund. This concern does not apply to venture capital as the business model does not create systemic risk. We use equity investment to finance growth, so while the companies we invest in are certainly not guaranteed to succeed, the worst that can happen is a loss of the capital invested. Further, prior to the Volcker Rule's passing, banks generally only invested a small percentage of their overall assets in venture capital. This is somewhat similar to our other limited partners, who often invest no more than a few percent of their total assets in venture capital. As an industry, we are a fraction of the size of either the hedge fund or private equity industries.

Assets Under Management (AUM) As of Dec. 31, 2016 ($ billions)



Source: NVCA 2017 Yearbook, Data Provided by PitchBook; hedge fund websites

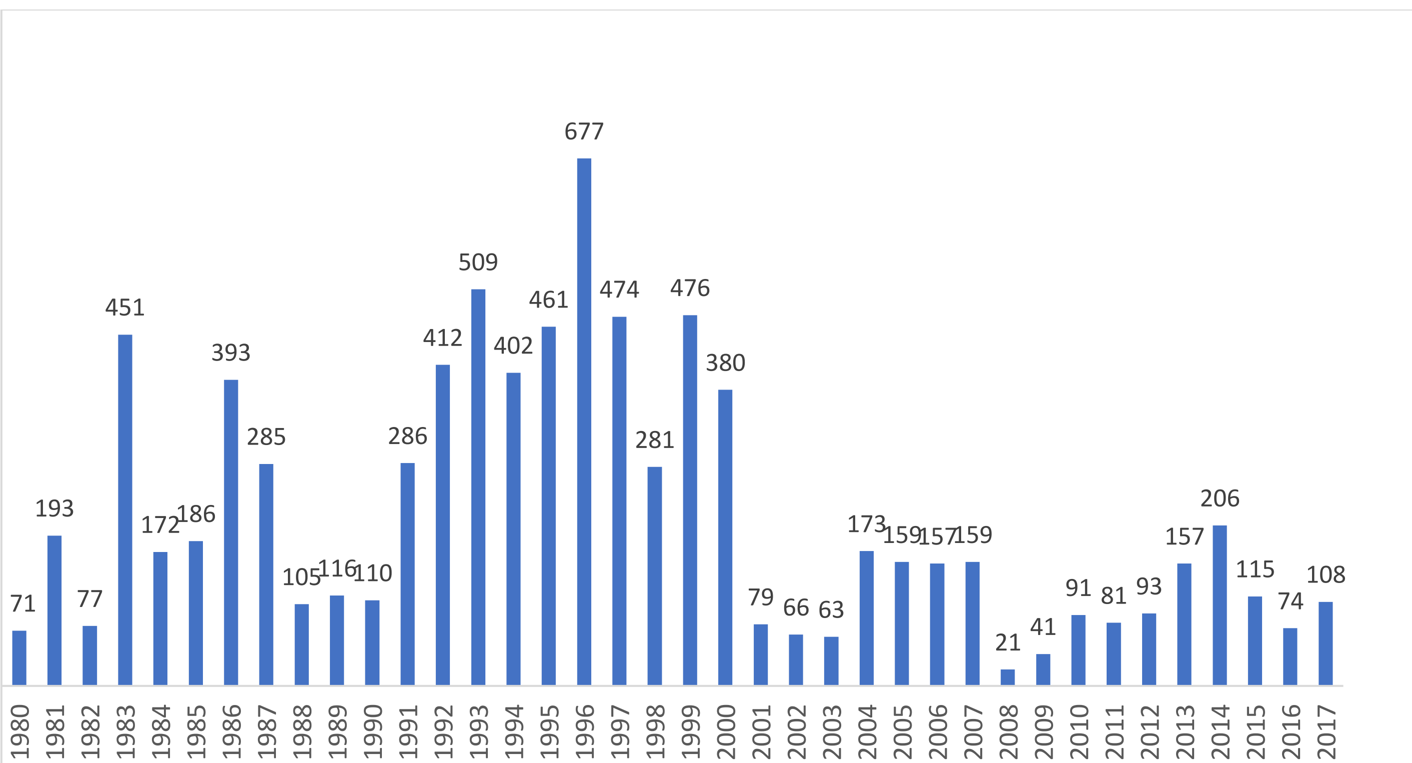
There was no intent by Congress to ban bank investment in venture capital funds during Dodd-Frank. In fact Chairman Dodd noted at the time that capturing venture capital was not his intent, at one point stating: "properly conducted venture capital investment will not cause the harms at which the Volcker Rule is directed." But the regulators unfortunately interpreted the covered funds prohibition to include VC investment. Almost overnight, a key source of financing for startups in the Midwest and other non-coastal areas of the U.S. disappeared. This prohibition has been particularly challenging to my colleagues in smaller firms because they have less access to the large institutional investors who are looking to make larger investments than they can absorb, and so often need to raise capital from a more diverse set of limited partners. Banks were often called anchor investors, as they would become a key limited partner in a VC fund that could attract other capital by offering a sort of validation of the fund.

The unfortunate effects of the Volcker Rule on the venture industry can be fixed quite simply: allow banks to invest in venture capital funds again. Congress can use the definition of venture capital fund crafted by the Securities and Exchange Commission (SEC) to define the universe of eligible funds. This would provide near immediate access to capital for high-growth startups that will create American jobs, innovation, and tax revenue, and much of these benefits would be in the regions for which we all support bolstering capital formation.

Encouraging More Public Companies

As mentioned earlier, the IPO markets are critical to the VC business model, and unfortunately fewer companies are choosing to go public today.

Total Number of U.S. IPOs by Year, 1980-2017



Source: Initial Public Offerings: Updated Statistics 1/17/2018 Compiled by Jay Ritter

Partly as a result, the U.S. now has about half the number of public companies than we did twenty years ago[4]. I believe there is a confluence of circumstances that have led to this point. First, the cost and complexity of being a public company has increased significantly over the last twenty years. Second, the research and market making infrastructure that previously supported small capitalization companies has collapsed. Finally, the culture of short-termism has advanced, which can be particularly damaging to the type of innovative companies we support as venture capitalists.

I applaud the House Financial Services Committee for their dedication to fixing this issue. The Committee has spent a great deal of time and intellectual energy trying to understand these root causes and finding solutions that can make it more attractive for startups to become public companies. The Jumpstart Our Business Startups (JOBS) Act was a great start, and the recent slate of bills the committee has worked on are a great way to build off of the success of the JOBS Act.

Developing and Empowering Our Aspiring Leaders Act

One bill I would like to highlight is the *Developing and Empowering our Aspiring Leaders* (DEAL) Act, sponsored by Representative Trey Hollingsworth (R-IN). The DEAL Act would direct the SEC to modify its definition of a venture capital fund to make secondary investments in emerging growth companies (EGCs) qualifying investments. A secondary investment is a share of a company purchased from anywhere other than the company directly. In the venture ecosystem, these shares generally come from founders, early stage employees, or investors (such as angel or seed investors) who may need to find liquidity for life events. With companies staying private longer, there are more significant amounts of secondaries included in venture capital financing rounds. It is considered a positive for VC investors to pick up these secondaries as A) it provides liquidity to participants in the entrepreneurial ecosystem when they need it, thus making it more attractive in general to participate in entrepreneurship, and B) the VCs are already partners in these companies, so it keeps their ownership structure clean.

Despite the fact that it's common practice for VC funds to acquire secondaries, these investments were determined to be nonqualifying by the SEC. Therefore, VCs are left with a choice: either limit their ability to participate in certain financing rounds and fit within the definition or incur hundreds of thousands of dollars (or millions in some cases) a year in compliance costs by becoming a registered investment advisor (RIA). The DEAL Act would make secondary investments in growth companies qualifying for purposes of the definition. This would allow VCs to continue providing equity investment to more of their portfolio companies, encourage patient capital investment, and long-term company growth. The modification would be limited in scope to equity investment by venture capital funds, activity that is generally a bipartisan priority.

I would like to thank Congressman Hollingsworth for his leadership. It is wonderful to see a Member of Congress put such hard work into a technical issue that has a real and positive impact on the venture ecosystem, and I hope to see the legislation pass through Congress and ultimately become law.

Research and Development Tax Credit:

Another issue that can help innovation investment would be an expansion of the ability of startups to offset their payroll taxes with R&D credits. It is a bit of an anomaly that when a company needs the R&D credit the most—in its growth phase—the credit has been largely unavailable because there needs to be taxable profits to offset. The *Protecting Americans from Tax Hikes* (PATH) Act of 2015 had a valuable

[4] "The U.S. Listing Gap," Craig Doidge, G. Andrew Karolyi, and Rene M. Stulz (July 2015), *available at* https://www8.gsb.columbia.edu/faculty-research/sites/faculty-research/files/finance/Finance%20Seminar/Fall%202015/Doidge_Karolyi_Stulz_Listing_Gap_July2015.pdf.

provision which allows companies under five years old with less than $5 million in sales to offset up to $250,000 in payroll taxes. This was a helpful development, and I would encourage Congress to expand this to $1 million to create parity with Canada's Scientific Research and Experimental Development Tax Credit Program. To encourage simplicity, I also think the eligibility definition should align with the criteria we currently use for Qualified Small Business Stock rules under Section 1202. This would create a meaningful boost to research-intensive startups.

Policies that Impact Participation in the Entrepreneurial Ecosystem

Helping startups obtain financing is a critical issue, but it must be paired with an ability for participants in the entrepreneurial ecosystem, if successful, to realize rewards for the risks they take and the value they create. Mr. Chairman and Senator Portman, thank you for your work during the recent tax reform bill to ensure that the taxation of stock options was not moved forward to a point where startup employees would have been receiving multi-thousand dollar tax bills with no money to pay the bill. The proposal to tax stock options at vesting would have had a devastating effect on American entrepreneurship, but thanks to your efforts we were able to avoid a major self-inflicted wound. I would also like to thank you for the work you did to include a deferral of taxes for employees of companies who must exercise their options but don't have a liquid market in which to sell their shares. Your work here will have an enduring impact on the attractiveness of helping to build new companies in the U.S.

Net Operating Loss Safe Harbor

Mr. Chairman, another issue I know you are familiar with that impacts growth companies is how net operating losses (NOLs) are treated as our companies go through different stages of the growth process. The vast majority of startups lose money in their early years as they put investment capital to work to grow their business. Some, such as biotechnology and medical device startups, can be completely pre-revenue for years while they develop their product and navigate the Food and Drug Administration (FDA) approval process. There are rules under Sections 382 of the tax code that govern how NOLs can be carried forward when there are ownership changes in a company. These rules were put in place with the intent to prevent loss trafficking, where a dying company is bought so the acquiring company can use its accumulated NOLs to offset their own tax liability. The rules require a company to calculate the delta between the amount of losses on its books and its fair market value every time there's an ownership change. If the delta is too high, the rules limit the amount of losses that can be carried forward.

Unfortunately, Section 382 was written without much consideration given to the startup financing model, where ownership changes are a common event. In fact, financing events like new fundraising rounds or an IPO can cause a growth company to run afoul of the rules. The upshot is that today Section 382 serves to wipe out the value of growth company NOLs in a broad range of ownership change transactions where the company is growing or being sold for a gain. This is very far from the intended purpose of the rules, and even worse, serves to depress startup valuations in our most capital intensive startups such as life sciences and renewable energy. And when one considers that the majority of NOLs accumulated by startups are for spending on R&D and salaries and hiring, I hope it is clear that action is needed to provide a safe harbor for growing startups from the NOL limitation rules under Section 382. Mr. Chairman, I know you've been a leader on this issue and we look forward to continuing our work with you and your office to find a solution, because I think we all should agree that it makes no policy sense to discourage our startups from investing in their growth.

Qualified Small Business Stock Rules

The qualified small business stock (QSBS) rules, which provide an exclusion of up to $10 million dollars (or 10X basis) in capital gains for investments in early stage companies quickly started gaining the attention of potential participants in the entrepreneurial ecosystem when the PATH Act made the 100%

exclusion permanent. If we could find ways to simplify the rules and create more certainty, I believe that QSBS could become one of the most powerful incentives for investing in regional venture capital funds. Noncoastal VC funds tend to be smaller and in need of more diverse sources of limited partners than those of us in the most prominent areas. Accredited investors can step in and help fill that hole, and QSBS is a major incentive for them to do so.

Carried Interest Capital Gains

One issue that is critical to the economics of the VC ecosystem is the tax treatment of carried interest. While it is mainly criticized as a hedge fund loophole, in reality a tax increase on carried interest would have the least impact on the hedge fund business model, and the harshest impact on the venture capital business model that funds small, high-growth companies. In fact, after last year's tax bill passed, including a provision which tripled the holding period necessary to realize long-term capital gains treatment of carried interest, I would question whether there is even a meaningful amount of hedge fund income that will be taxed at long-term capital gains rates in 2018, as most hedge-fund activity is relatively short-term.

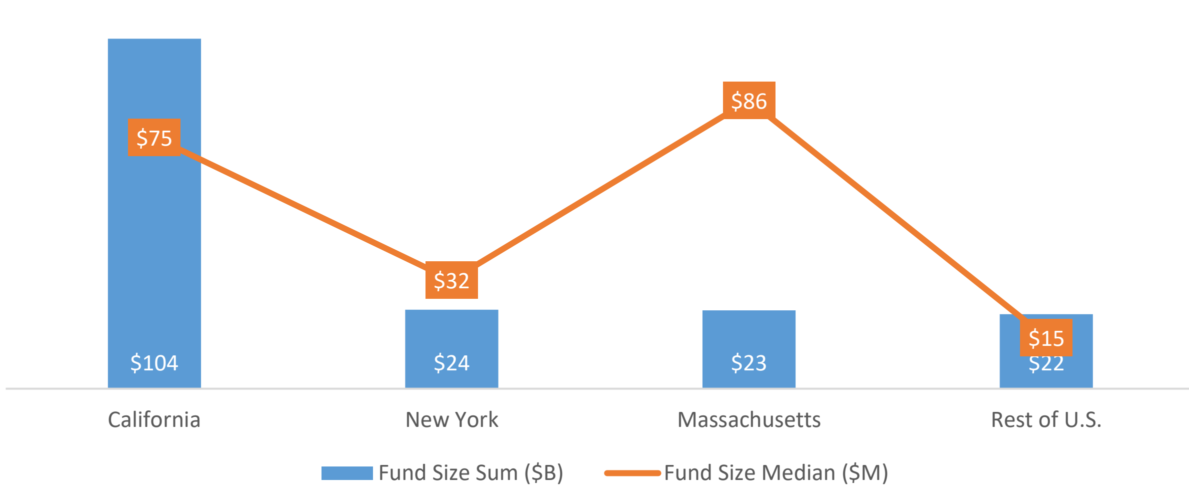
Carried interest is of particular importance to the VC business model for three primary reasons:

1) Venture capital is far smaller than other asset classes, so VCs are more dependent on carried interest to make the economics work. In fact, in many smaller VC funds carried interest is the sole economic incentive to participate in venture capital since fees generated from the funds (which are calculated as a percentage of the size of a fund) are not even enough to provide a salary to the general partners. As you will see below, the median size VC fund in states *other* than California, Massachusetts, and New York is about $22 million dollars in assets under management.

2) Venture capital holds assets for far longer than any other asset class. Arbitrarily applying ordinary income rates to carried interest that takes a decade to realize will have a particularly depressing effect on venture capital participation. Other asset classes could process multiple funds in the same time period it takes VCs to wind up one fund.

3) Venture capital is high risk, and a majority of funds are not successful enough to even realize carried interest.

VC Funds Raised by State Headquarter 2012-Q2 2017, Sum and Median



Source: PitchBook

I understand that carried interest has become a hot button political issue, but I implore the Congress to look through the rhetoric and understand that significantly increasing taxes on carried interest would be devastating to the capital formation environment for startups in the U.S. We are not asking for special treatment, just that we continue to receive the same tax treatment as anybody else who takes a risk and creates value in the economy.

Conclusion:

These are a number of different issues that can positively or negatively impact capital formation for startups in the U.S. While the technology we back may be complex, the policy formula to grow our ecosystem is not. Make the rules of the road simple and clear, encourage participation, and make long-term risk investment as attractive as possible. There is no quick fix here, but good policymaking can pay dividends for generations, as we have all enjoyed from the decisions of our predecessors.

Thank you to the committee for your interest in this important topic. I stand ready to answer any questions.