March 18, 2021

The Honorable Pat Toomey
Ranking Member
Senate Banking, Housing and Urban Affairs Committee
U.S. Senate
Washington, D.C. 20510

Dear Senator Toomey:

On behalf of our nation's venture capital (VC) investors and the entrepreneurs they support, I write in response to your request for proposals to foster economic growth and capital formation. Thank you for this opportunity to share ways that policy can increase economic growth and job creation by facilitating capital formation. This issue is of particular importance to our community as VC-backed companies have made up ***a majority*** of all companies that have gone public over the previous seven years in a row.[1]

Below is background on venture capital and a number of proposals that would support capital formation in America's startup ecosystem. We look forward to working with you on these important issues.

Background on Venture Capital

As background, venture capitalists are investors in the nation's startups. VCs create partnerships with institutional investors to combine the capital held by pension funds, endowments, family offices and others with their talent and expertise to make risky, long-term equity investments into innovative startups. These are generally partnerships that last ten to fifteen years, building investments far longer than any other asset class.

VCs generally provide minority equity investment across multiple financing rounds, supporting startups through their maturation process. This capital is used to conduct research, expand workforces, build out new facilities, and generally focus on growth activities that create long-term value. Companies backed by venture capital predominantly focus on technological innovation, including IT hardware and software, biotechnology and medical devices, and climate and sustainability technology.

VC-backed startups begin as small businesses and oftentimes are nothing more than an idea (as was the case with Moderna), but their objective is significant growth and scale opportunity.

[1] https://site.warrington.ufl.edu/ritter/files/IPO-Statistics.pdf

Startups often compete against large corporate incumbents, yet their timeline to achieve profitability is quite long and failure rates are high. These are new companies taking incredible risks against long odds to become the next generation of successful American businesses. VCs hope that startups succeed against the odds and grow into successful companies, but in a majority of cases companies will fail.

Last year, venture capital funds provided more than $130 billion in capital to over 10,000 startups to start and grow their new businesses. This averages out to about 28 companies raising a total of $365 million in venture funding in the country every single day. These companies spanned all 50 states and the District of Columbia, 242 Metropolitan Statistical Areas (MSAs), and 397 Congressional Districts.[2]

Economic Impact of Startup Activity

New company formation is what has set the United States apart as the most dynamic economy in the world. From the Ford Model T, to Apple, to most recently Zoom and Moderna, the modern American economy has relied on entrepreneurship to fuel growth, solve challenges, and expand opportunity.[3]

A research paper produced by Stanford University found that of the 1,339 companies that went public between 1974 and 2015, 42 percent trace their roots to venture capital. Those venture-backed companies account for an astounding 85 percent of all research and development spending by companies that have gone public since 1974.[4]

Technology-focused entrepreneurial activity is particularly important to creating economic opportunity for American workers. A recent report from the University of North Carolina's Kenan Institute of Private Enterprise found that total high-technology employment in the U.S. grew by around 20 percent from 2007-2016, and that these jobs both *paid higher median wages* and *were created faster* coming out of the financial crisis than non-high-technology jobs in states across the U.S.[5] This illustrates a fundamental trend in the modern economy: the path to greater economic opportunity for American workers runs through technological progress and long-term investment.

PROPOSALS

I. Modernize the SEC's Definition of Venture Capital Fund (DEAL Act)

When Congress mandated in Dodd-Frank that hedge and private equity funds become registered investment advisors (RIAs), they directed the Securities and Exchange Commission (SEC) to exempt VC funds and left it to the agency to define venture capital. Failure to meet this definition requires a venture capital fund to register with the agency as an RIA, while funds that do qualify for the exemption file annual reports with the SEC under exempt reporting advisor

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[2] NVCA 2020 Yearbook, Data Provided by Pitchbook, *available at https://nvca.org/research/nvca-yearbook*

[3] Jeff Farrah (NVCA Blog), *Creating the Next Moderna: What VC Offers the World and 3 Public Policy Lessons* available at https://nvca.org/creating-the-next-moderna-what-vc-offers-the-world-and-3-public-policy-lessons/.

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

[5] *Frontiers of Entrepreneurship* (2020 Trends Report, University of North Carolina – Chapel Hill, *available at* https://frontiers.unc.edu/wp-content/uploads/2020/01/2020-TrendsInEntrepreneurshipReport.pdf

(ERA) status. ERAs still register with the SEC but have a lower regulatory burden and spend significantly less in annual compliance costs. A survey by NVCA found members who are registered have about eight times the annual compliance costs of those firms who are ERAs.

The SEC promulgated this definition in 2011, and in the succeeding decade, several trends in the venture capital industry have created pressure on the requirements for "qualifying" investments—defined as a direct investment into a private company. As companies have stayed private longer, the most significant trend has been the increased prevalence of secondary investments in venture financing rounds. Other challenges arise when biotech VCs want to support their portfolio companies with direct financings shortly after the company has gone public, if VCs make a blockchain investment, or if VC funds want to invest in emerging VC funds, particularly to support entrepreneurship opportunity in areas off the coasts.

Despite contributing to positive economic activity, under the current definition of a venture capital fund these investments are all considered "non-qualifying" investments. Surpassing the current definition's limited threshold for nonqualifying investments can force the VC funds to lose their exempt status.

- This is having several consequences for capital formation:
    - Early stage VC funds and angel investors are having more difficulty finding liquidity as it's generally either them or company founders whose shares larger VC funds are acquiring;
    - Biotech companies must worry about getting cut-off from access to capital once they go public if their VC investors can't take on more nonqualifying investments;
    - New VC funds in emerging regions have more trouble raising money from other VCs.

The global pandemic most notably impacted the early-stage venture ecosystem during Q2 in 2020 as first-time financings dropped to a multi-year low as a proportion of overall VC activity. 316 seed financings were completed during Q2, a significant decline from the average of roughly 650 completed seed financings each quarter in the prior year.[6] The proposed modification of the current definition would reduce barriers for encouraging early-stage investment activity. As noted above, most of the secondary shares acquired by VC funds, currently nonqualifying investments, are those from angel investors, seed stage funds, and company founders. By making secondary investments and fund-of-funds investments qualifying, the SEC would increase liquidity in the early-stage ecosystem and for emerging fund managers, crucial elements to the overall startup ecosystem.

PROPOSAL: Pass the *Developing and Empowering our Aspiring Leaders Act*

The *Developing and Empowering our Aspiring Leaders* (DEAL) *Act* is the legislative solution to this challenge and would encourage capital formation for startups by directing

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[6] NVCA-Pitchbook Venture Monitor Q2 2020; *available* at https://nvca.org/wp-content/uploads/2020/07/Q2_2020_PitchBook_NVCA_Venture_Monitor-FINAL.pdf.

the Securities and Exchange Commission to make a percentage of secondary investments qualifying for purposes of the definition of a venture capital fund. Passage of the DEAL Act would allow VC funds to continue to follow their portfolio companies along their growth path without fear of triggering a significant regulatory burden. Following introduction and leadership by Representative Trey Hollingsworth (R-IN), the House of Representatives passed the DEAL Act as part of the *JOBS and Investor Confidence Act of 2018* with a strong bipartisan vote. A Senate companion bill has also been introduced by Senator Mike Rounds (R-SD).

II. Expand Emerging Growth Company (EGC) Status

One of the most successful aspects of the Jumpstart our Business Startups (JOBS) Act was the creation of the EGC designation for growth companies accessing the public markets. This designation provides a more flexible regulatory regime for companies who have been public for less than five years with under $1.07 billion dollars in annual revenues and are not yet large accelerated filers. EGC designation smooths the transition to the public markets for innovative growth companies, making an IPO relatively more attractive. Research has found that about 90 percent of companies going public are EGCs.[7]

PROPOSAL: Two improvements to the eligibility criteria for EGCs would create greater certainty around regulatory status for companies considering whether to go public:

- Extend the timeframe for EGC eligibility from five years to ten years for certain exemptions and disclosure requirements. Existing legislation, the *Helping Startups Continue to Grow Act* sponsored by Representative Bryan Steil (R-IN), would make these improvements for small capitalization companies.
- Provide a transition period of one year for EGCs who trigger large accelerate filer status when their public float exceeds $700 million for the first time.

Taken together, these changes would provide companies making the determination about whether to go public with greater confidence in the expected regulatory burden they will face.

III. Require Short Position Disclosure

A short position disclosure regime would support innovative small-capitalization companies by requiring that investors disclose material short positions they hold. There currently exists an information vacuum which encourages certain investors to promote misleading information and inaccurate data that can drive a company’s stock price down while hiding the true source and financial interest behind those efforts. Small capitalization companies are particularly vulnerable to these so-called “short and distort” campaigns as they often have shallow liquidity and limited research coverage, meaning their share price can move quickly based upon investor sentiment.

PROPOSAL: Require investors to disclose material short positions. A similar disclosure requirement for material long positions already exists and has been successful in making U.S. capital markets more efficient.

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[7] https://www.ey.com/en_us/assurance/accountinglink/2019-trends-in-us-ipo-registration-statements

IV. Allow EGCs to Choose Trading Venues

With the proliferation of new trading venues that have been created over the last twenty years, fragmentation of shares trading across venues has become an increasing challenge for smaller companies with less liquidity. Fragmentation leaves smaller companies more vulnerable to short-term volatility that can further erode liquidity and dry up research coverage.

> ***PROPOSAL:*** Provide EGCs the opportunity to opt out of unlisted trading privileges (UTP) and select the venues that can trade their securities. Providing EGCs this choice will improve trading quality for these companies and improve capital formation in the public markets.

V. Review Regulatory Barriers to Research Coverage for EGCs

A lack of consistent research coverage has become one of the most significant disincentives for smaller companies trying to decide whether to become publicly listed. Research coverage for small-capitalization companies in particular has dropped dramatically, with a recent report finding that about 61 percent of all companies listed on a major exchange with less than a $100 million market capitalization have no research coverage.[8]

Research coverage is particularly important for companies with thinly traded stocks, as name recognition is often low, trading can be volatile, and the universe of investor interest is limited.

> ***PROPOSAL:*** Request a study to examine ways that policy can reduce the barriers to research coverage for EGCs.

VI. Support New Options for Companies to Access the Public Markets

Recent activity around direct listings and Special Purpose Acquisition Companies (SPACs) have created new ways for companies to access the public markets outside of the traditional initial public offering (IPO) process. Competition in methods to become publicly listed is a positive development that can drive down costs and improve access to the public markets. In particular, the SEC's recent move to approve direct listings with an ability to raise primary capital is helping EGCs access the public markets by driving greater competition among public listing options.

Policymakers should continue to monitor this evolving situation and pursue further areas of engagement in order to encourage greater competition in public listing options.

VII. Implement an Effective Blockchain Regulatory Regime

A number of NVCA members believe that blockchain holds the promise to be the next transformative industry, provided the policy environment allows entrepreneurs to fully experiment with the technology in the U.S. The current discussions around blockchain have many similarities to the regulatory policy conversations that occurred during the rise of previous generations of new industries, such as biotechnology and the commercialization of the Internet. In each of these cases, doubts amongst policymakers proliferated and policy proposals were considered that could have prevented American leadership before the full promise of the

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[8] CapitalIQ as of June 9, 2017

technology was realized. Fortunately, cooler heads prevailed, and as a result, the U.S. has been the unquestioned global leader in technological innovation since World War II.

The commercialization of blockchain technology is in its infancy, but a glimpse into the current efforts of blockchain entrepreneurs offers a clear illustration of its potential. As we speak, blockchain entrepreneurs are working to apply the technology to solve critical societal challenges like access to financial services for the unbanked and underbanked, expanding economic opportunity, fighting climate change, and providing a market-based solution to technology and financial services industry concentration. These individuals are undertaking the risky endeavor of entrepreneurship to explore how the power of open protocols can fundamentally redesign how individuals and businesses use the internet.

> ***PROPOSAL:*** Implement an effective blockchain regulatory regime. The bipartisan *Token Taxonomy Act* provides a base of work for policymakers to develop and implement an effective blockchain regulatory regime. Establishing a clear regulatory framework for blockchain technology is a difficult task, as with any emerging technology field, but it is a priority shared by many policymakers on both sides of the aisle and most industry participants. We urge policymakers to do what previous generations of regulators were able to accomplish when faced with similar challenges in innovative technologies: construct a regulatory regime that allows the technology to develop in a safe and sustainable manner.

Conclusion

As your committee explores these and other ideas to increase economic growth, we encourage you to not lose sight of the critical role venture capital plays in spurring economic growth in the country. Through patient capital investment and hands-on mentorship with entrepreneurs, venture capital is the rocket fuel that propels innovation and builds emerging growth companies to become leaders of the American economy. Thank you for your attention to this important matter. NVCA is encouraged by the conversation and excited to work with you on solutions to jumpstart economic growth through new company formation.

Sincerely,

Bobby Franklin

Bobby Franklin
President and CEO