



NVCA's 4-Pillar Plan to restore liquidity in the US VC industry

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Given the proven contribution of venture-backed companies to America's economic growth, the NVCA sought analysis and recommendations from leaders throughout the capital markets ecosystem over the last several months. The resulting set of proposals looks to the venture capital industry, investment banking, accounting professions, law firms, stock exchanges and the government to enact measures to restore a vibrant IPO environment once the overall economy stabilizes.

The initiative was spearheaded by NVCA chairman and co-founder and general partner at DCM, Dixon Doll, who articulated the important work that has both been completed and has yet to be done.

Venture-backed public companies are critical to US economic growth

The revitalization of the venture-backed IPO market is critical to US economic recovery and to the ongoing viability of America's competitiveness. A report released in May by Global Insight estimated that in 2008 public companies that were once venture-backed accounted for more than 12 million US jobs and \$2.9tr in revenues, which equates to 21 per cent of US GDP. Further, it is estimated that 92 per cent of job growth at these companies occurs once the company enters the public markets.

The NVCA Four Pillar Plan to restore the venture-backed IPO market

At the core of the issue is a recognition that today's market environment is challenging with respect to the issuance of small cap IPOs. There are multiple reasons as to why this is the case including the high costs of going public, the constituents involved in the process, and the restrictions placed on potential public companies. The NVCA recommendations, which seek to address these issues, comprise four categories or pillars, two which focus on changing behavior in the venture capital market and two which involve the government exploring policies conducive to venture-backed IPOs.

Pillar I: Ecosystem Partners

Within the last decade, venture-backed companies have been faced with fewer choices as it relates to investment banks and accounting firms that will assist in the IPO process. While the major investment banks continue to operate, the "four horsemen" boutique investment banks of the 1990s (Alex Brown, Hambrecht & Quist, Montgomery Securities, and Robertson Stephens),

which specialized in IPOs of venture-backed companies, no longer exist. Further, the fall of Arthur Andersen and the resulting pressure placed on the Big Four accounting firms has, in many markets, left a void in terms of quality auditing services available for these smaller companies.

Against this backdrop, the NVCA believes that the venture capital industry must do more to promote alternative ecosystem partners while engaging with existing members to identify ways to better serve the needs of emerging growth companies. The Association has begun to engage in talks with boutique and major investment banks as well as the Big Four and other public accounting firms about how they can also better serve the needs of small-cap companies. The NVCA also intends to encourage the use of a broader array of service providers such as the “Global Six” including Deloitte, Ernst & Young, Grant Thornton, KPMG, PricewaterhouseCoopers and BDO Seidman.

Pillar II: Enhanced Liquidity Paths

There is consensus among many within the capital markets ecosystem that the distribution system that connects sellers and buyers of venture-backed company new issues is broken. There are many drivers behind this disconnect including mismatched expectations in terms of issue size, the lack of sell side analysts, and the propensity of hedge funds to buy and sell stock quickly. All of these factors contribute to a lack of an adequate distribution channel and considerable post-IPO market volatility.

To offer small venture-backed companies an enhanced distribution system for the sale of initial stock, the NVCA endorses concepts such as Inside Venture which is a private market platform that connects qualified companies that intend to IPO within 18 months with pre-screened cross-over investors. These buyers commit to buy and hold these stocks for the long term. Other providers with similar models include Portal Alliance (NASDAQ), SecondMarket and Xchange. Additionally, the NVCA will help raise awareness about pro-active M&A roll up strategies of smaller portfolio companies to achieve IPO critical mass and global alternatives to the US public markets.

Pillar III: Tax Incentives

The NVCA has long asserted that the government must support a tax structure that fosters capital formation and rewards long term measured risk taking. To support a more vibrant IPO market, the US must maintain tax policies that have been proven to encourage venture capital investment so that the pipeline of promising IPOs is as robust as possible. Further, Congress should consider adopting new tax incentives which would stimulate IPOs, at least in the short term.

The NVCA will continue to advocate strongly for a capital gains tax rate that is globally competitive and preserves a meaningful differential from the ordinary income rate. The Association asserts that venture capitalists who are successful in building new companies should continue to be taxed at a capital gains rate for any carried interest that is earned over the long term. The Association also intends to explore the possibility of a onetime tax incentive for buyers and holders of IPOs as well as increasing the holding rate for capital gains status to two or more years.

Pillar IV: Regulatory Review

From a regulatory perspective, the last decade has been characterized by a series of broad sweeping regulations aimed at curbing serious abuses within the financial system but fraught with unintended consequences for small pre-public and public companies. From Sarbanes Oxley (SOX) to the Global Settlement to Reg FD, small venture-backed companies have been faced with costly compliance and increasing obstacles to enter the public markets as a result of regulations intended for larger multi-national corporations. The NVCA strongly supports regulation and protecting investors where necessary but does not support a “one-size-fits-all” regulatory approach.

To wit, the NVCA will advocate for a full systematic review by the Securities and Exchange Commission of recent regulations which impact small cap companies. This review would include interpretations of SOX, pre-IPO financial reporting requirements, the separation of analyst and investment banking functions, and private placement requirements. There are opportunities within existing regulations to tier compliance so as not to overburden emerging growth pre-public and public companies at a time when they need support from the government, their auditors, and the markets.

The National Venture Capital Association (NVCA) represents approximately 460 venture capital firms in the US. NVCA's mission is to foster greater understanding of the importance of venture capital to the US economy and support entrepreneurial activity and innovation. The NVCA represents the public policy interests of the venture capital community, strives to maintain high professional standards, provides reliable industry data, sponsors professional development, and facilitates interaction among its members. For more information about the NVCA, please visit www.nvca.org.