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"Reducing Barriers to Capital Formation, Part II"

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Chairman Garrett, Ranking Member Maloney, my name is Ray Leach. I am the founding CEO of Jumpstart, Inc., a Cleveland-based nonprofit that builds partnerships amongst public, private, philanthropic and institutional organizations who are focused on supporting and investing in a diverse set of Ohio startup companies. We typically seek out high-potential startups who demonstrate the potential to create significant new jobs, wealth, collective economic impact and direct financial returns. Along with such partners as the Ohio Third Frontier, the Economic Development Administration and the Small Business Administration, JumpStart works one-on-one with entrepreneurs to assist them with critical business development activities including raising private capital, testing the commercial viability of their product or service and generating first revenues. While we have provided services to hundreds of Ohio companies, JumpStart has also directly invested $30 million into 76 Ohio startup technology companies which have gone on to raise more than $300 million in private capital and have created more than $1 billion in total economic impact in Ohio. In the process, these companies have created 2,000 total jobs and have generated millions of dollars of financial returns to date, which have then been reinvested into additional investing and support activities for entrepreneurs in Ohio.

I am also a member of the Board of Directors of the National Venture Capital Association, on whose behalf I am testifying today. Venture capitalists are committed to funding America's most innovative entrepreneurs. We work closely with them to transform breakthrough ideas into emerging growth companies that drive U.S. job creation and economic growth. According to a 2011 study by IHS Global Insight, companies that were founded with venture capital accounted for 12 million private-sector jobs and $3.1 trillion in revenue, or 22 percent in GDP, in 2010. Venture-backed companies also tend to generate more jobs and revenues than their non-venture peers. A recent study by the Institute for Exceptional Growth Companies (IEGC) and Pepperdine University's Graziadio School of Business and Management found that venture-backed companies generate 846 percent more revenue growth and 608 percent more jobs than comparable non-venture companies in the five years after they go public or merge with another company.[1]

Indeed, venture-backed companies are true drivers of the U.S. economy. That is one of the reasons why NVCA supported the passage of the JOBS Act of 2012 – and in particular, the "IPO On-Ramp" provision contained therein. My colleague Kate Mitchell, a former NVCA Chairman, testified before this very subcommittee in support of the bill in December of 2011. I want to thank this committee for its work on making the JOBS Act possible. I also want to thank the Members here today for continuing to direct their attention to regulatory and market concerns that affect companies once they have gone through an IPO. NVCA supports this continued focus on how to make participation in the public markets a better experience for small companies.

For this reason, I would like to take the opportunity today to provide you with an update on where the market for initial public offerings, or IPOs, stands from the venture capital

[1] http://bschool.pepperdine.edu/newsroom/wp-content/uploads/2012/12/Paglia-Harjoto-PE-VC-11.29.2012-IEGC.pdf.

perspective, and what effects the JOBS Act has had on the IPO market and for our portfolio companies.

The Value of IPOs to America's Innovation Ecosystem

To properly contextualize the importance of IPOs to emerging growth companies and the investors who fund them, I will briefly review the process by which venture capital guides and funds the growth of innovative startups.

Venture capitalists invest at the earliest stages of a company's development – often before a product or service is more than just an idea. This involves significant entrepreneurial risk, which severely limits capital sources for such companies. Yet, venture capitalists assume this risk alongside the company founders by providing capital in exchange for an equity stake in the company. During this investment stage, venture capitalists provide more than just money to the company. Typically, VCs take seats on the boards of directors and participate actively in company operations and management of personnel. This commitment includes providing strategic counsel regarding development and production, making connections to aid sales and marketing efforts, and assisting in hiring key management. As part of this process, the venture capitalist also guides the company through multiple rounds of financing. At each point, the company must meet certain milestones to receive fresh funds for continued growth.

The venture investor's goal is to grow the company to a point where it can go public or be acquired by a larger corporation at a price that exceeds the amount of capital invested. We call this process an "exit." Typically, when a venture-backed company exits the portfolio, the VC distributes the profits to the fund's investors, or limited partners, which most often are public employee pension funds, endowments and philanthropic foundations.

Of these two exit options, a successful IPO provides some important advantages over a merger or acquisition. First, an IPO typically raises more capital for hiring, product development and expanded distribution. Our data show that 92 percent of job growth from these firms occurs after a company goes public. In contrast, mergers and acquisitions often result in job losses, at least in the short term, as the acquiring company looks to eliminate redundant positions between the two enterprises. Second, an IPO enables all types of investors to participate directly in the company's growth as they look to build their portfolios and retirement accounts. It also provides financial benefits to employees of venture-backed firms who have also earned equity in the firm pre-IPO. Third, IPOs typically generate meaningful returns for the pension funds, endowments, foundations and other limited partners who have pooled their money with that of the VCs to invest. Lastly, a company that goes public has the potential to transform regional economies and communities in significant ways. Often, new innovation and entrepreneurship will "spin out" of these entities, creating an even more vibrant ecosystem in regions that otherwise would not be able to foster this growth organically. One only has to look to see what Medtronic did for Minneapolis, Dell for Austin, and Qualcomm for San Diego to understand why IPOs are so critical to these communities and regional economies.

The IPO Market and The JOBS Act Today

The decline of the U.S. IPO market over the past 15 years has been well-documented. From 1990 to 1996, 1,272 U.S. venture-backed companies went public on U.S. exchanges, yet from

2004 to 2010, only 324 did so. Most analyses have pointed to a complex series of changes in the regulatory environment and related market practices that have driven up costs and uncertainty for emerging growth companies looking to go public – to the point where most such companies began to position themselves for acquisitions instead.

Recognizing the urgency of this trend and its dire implications for U.S. job creation and economic growth, Congress passed the JOBS Act of 2012. A multi-faceted, measured and nuanced approach, the JOBS Act aimed to revive the U.S. IPO market in part by rebuilding the pathway by which small companies reach the public markets. It did so in three innovative ways: first, it recognized emerging growth companies (or EGCs) as a unique category facing acute challenges in accessing public capital. Second, it provided a limited, temporary and scaled regulatory compliance pathway, which the IPO Task Force referred to as the On-Ramp, that aimed to reduce the costs and uncertainties of accessing public capital. As part of this pathway, EGCs could file with the SEC confidentially and "test the waters" before going through with an IPO. Third, it intended to improve the flow of information to investors about the initial offerings for emerging growth companies, so that they would be easier to understand and invest in.

A little more than a year after its passage, the urge to assess the impact of the JOBS Act by examining the state of the IPO market today is understandable. In doing so, however, we must look at the entire picture and recognize the complexity of the factors at play in the markets today. We should also bear in mind that some provisions of the JOBS Act have yet to be enacted, and we encourage regulators to complete this important work.

When President Obama signed the JOBS Act in April 2012, the NVCA assumed that any significant uptick in IPO activity would likely trail the law's implementation by at least a year or more. Even with the On-Ramp provisions, the process of preparing to file for an IPO is lengthy and complicated. Many of our portfolio companies had already put themselves on the M&A track, and that course is not easily altered. We also assumed that continued uncertainty in the financial markets could further delay or suppress interest on the part of emerging growth companies in going public. While the markets appear to be in the midst of a sustained rally, this development is still somewhat recent.

A topline review of IPO market numbers since April 2012 suggests that our assumptions so far have been correct. Only 49 venture-backed companies went public in 2012, which was two less than in 2011. This year, only eight such companies went public in the first quarter. However, the second quarter has brought a significant improvement, with 21 venture-backed IPOs – bringing the year's total to 29. A year with 100 or more venture-backed IPOs would be considered a strong year, so we are hopeful that the pace of 20 or more per quarter will continue.

These numbers may seem underwhelming, but they reveal only a fraction of the impact that the JOBS Act is having within the small-company ecosystem. Since the law's passage, more than 500 companies have registered with the SEC as emerging growth companies. That is 77 percent of all companies who have filed over this time. Of these, 63 percent have used the confidential filing provision[2]. In fact, it is estimated that a record number of companies – more than 200, in fact – are currently in registration for IPOs. Finally, micro-cap IPOs – meaning those with less

[2] Source: Latham & Watkins Report (April 2013); Dealogic/NYSE Research, includes only companies who listed or filed to list on a national exchange.

than $250 million market cap – have constituted 40 percent of IPOs so far in 2013 – up from 21 percent in 2012.[3]

This surge of renewed interest in the public markets on the part of growing companies aligns with what my fellow venture capitalists and I see every day when we work with our portfolio companies. This contrasts starkly with prevailing attitudes among so many company founders and management teams just a few years ago. Back then, the obstacles on the way to going public, and compliance burdens they would incur if successful, hardly seemed worth risking their companies over. Today, thanks to the On-Ramp and other provisions, many companies are again committing the time and resources required to explore IPOs as an option.

For just this fact alone – the revival of interest in IPO market on the part of small companies – my colleagues and I consider the JOBS Act to be a major success. It remains an exciting first step on the path toward renewing the health and primacy of the U.S. public markets.

After the IPO

As the statistics suggest, many more companies are exploring the process of going public than are completing it. While the JOBS Act has reopened and smoothed the road to the public market for emerging growth companies, that market remains a very difficult place to grow a company.

Today's market structure continues to favor the short-term, high frequency trading of large-cap stocks by investment banks. In this environment, small-cap stocks struggle to achieve visibility

[3] Source: Dealogic, ECM Analytics. Renaissance Capital estimate

and liquidity. In the prior market era, small issuers could help support their small-cap stocks by publishing analyst research about the companies and employing market makers to spur interest among investors, but current market economics no longer support these activities. This lack of information and liquidity has made it difficult for investors who want to invest in small-cap stocks as part of a long-term, fundamentals-based investing strategy to justify buying small-caps at an IPO and holding onto them in the aftermarket. This development hurts small companies and investors alike.

We know that the committee is aware of these issues, and that a robust debate is already underway regarding what factors may be driving them. Each market participant sees these issues from their own perspective, and we support the committee's continued diligence in seeking out the full panoply of marketplace perspectives before considering any solutions.

As venture capitalists, we tend to see the markets through the eyes of our portfolio companies – even though it is most often the point where VCs exit the picture. From that perspective, we view the current market challenges within the context of one overarching question: how can we encourage more investors to buy emerging growth company stocks at the IPO and hold them for the long term?

Unfortunately, NVCA does not know the answer to that question yet. Nor do we believe that there is one single answer to it – or one single stakeholder who holds the key to providing it. What we do know, however, is that all marketplace participants must begin working more closely and deliberately together to find the answers – today. That's because the toll that the moribund IPO market has taken on our economy over the past decade – terms of lost innovation, lost job creation and lost economic growth – grows each day. And each day, our international competitors come closer to capturing what we are in the midst of losing – be it through market reforms, capital formation-friendly policies and incentives, or developing their own cultures of risk-taking and entrepreneurship.

That's why this footing of discussion that we have been on since the passage of the JOBS Act must move once again to a footing of action. We know from history that markets work best when they are vibrant and offer a fair shot to all participants. We also know from experience that when market participants work together as part of working groups, task forces and other similarly structured engagements, they can create the context for and generate the momentum toward meaningful legislation. That's what happened with the IPO Task Force in 2011 – in which NVCA played a critical role – and with similar groups, who ultimately helped provide the impetus for the JOBS Act. As the numbers suggest, that piece of legislation has done much to address the challenges currently complicating the first half of the IPO process.

Now market participants must turn our attention to the second half of that process: life as a public company. As was discussed at the recent Treasury Department conference on Access to Capital, we believe that participants from the entire capital markets ecosystem – not just the small- and mid-cap segments – must participate. Once again, NVCA will gladly lend its voice to the discussion.

We are confident that such a process can work once again. Despite the apparent fragmentation and divergence of interests prevalent in today's environment, all of these players still share one key incentive: building a healthy marketplace in which the greatest number of Americans can participate with confidence and trust.

Conclusion

The U.S. capital markets system remains the most powerful engine for capital formation in the world. However, the health and vibrancy of the IPO market plays a critical role in the long-term sustainability of that system. Therefore, we must continue to work together diligently to understand the challenges facing this critical market segment and engage in dialogue that can produce solutions that benefit all stakeholders. If we succeed in reviving the U.S. IPO market, we can re-energize U.S. job growth and ensure that new generations of innovative emerging growth companies will continue to grow into the leaders of tomorrow's economy.

In closing, I want to personally thank you for the opportunity to discuss these important issues with you today. I look forward to answering any questions you may have and, I thank you for your attention to this critical issue.