

Joint Economic Committee Hearing

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“Driving Innovation and Job Growth through the Life Sciences Industry”

Testimony of:

Mark G. Heesen

National Venture Capital Association

Arlington, VA

Introduction

Chairman Casey, Vice Chairman Brady and members of the Committee, my name is Mark Heesen and I am president of the National Venture Capital Association (NVCA) based in Arlington, VA. The NVCA is the only national trade group representing venture capitalists. Our 400+ member firms invest in start-up companies across the country as well as globally in high tech industries such as life sciences, information technology and the clean technology sectors. We estimate that our membership comprises more than 90 percent of the venture capital under management in the U.S.

It is my privilege to be here today to share with you the role of venture capital investment in start-up companies – and how that role contributes to economic growth and innovation in the United States, particularly in the areas of life sciences. We appreciate the opportunity to offer a transparent view into our world and answer any questions the Committee might have.

The Fundamentals of Venture Capital Investing

Venture capital funds typically are organized as private partnerships with a significant percentage of capital provided by qualified institutional investors such as public and private pension funds, universities and endowments, private foundations, and to a lesser extent, high net worth individuals. These investors, referred to as the limited partners (LPs), have benefited greatly from the high risk/high reward exposure afforded by

venture capital as a relatively small component of their diversified investment portfolio. The venture capitalists that seek out start-ups for investment are the general partners (GPs), and they also supply capital for the fund from their own personal assets.

A venture fund is typically structured with a fixed term of at least 10 years, sometimes extending to 12 or more years. At the outset a limited partner commits a fixed dollar amount to the fund. As the GPs identify a new idea or company for investment, they make “capital calls” from their LPs, essentially collecting a portion of the capital commitments to make the investment. Further capital calls are made as each portfolio company becomes ready for a new tranche of investment by meeting milestones or growth trajectories. When a portfolio company has reached either stand-alone stability and sustainability, or when it needs to access the deeper resources of the public capital markets, the GP’s “exit”, through an initial public offering (an IPO) or an acquisition by a larger company, and the liquidity from these “exits” is distributed back to the limited partners. Limited partners may not otherwise withdraw capital during the life of the venture fund.

After the venture fund is formed, the GP’s job is to find the most promising, innovative ideas, entrepreneurs, and companies that have the potential to grow exponentially with the application of the venture capital expertise and investment. Often these companies are formed from research that spins out of university and government laboratories. Because the venture industry has historically focused on high technology areas such as information technology, life sciences, and clean technology, we rely a great deal on these labs to feed our pipeline.

Once a promising opportunity has been identified, venture capitalists vet the entrepreneur and his or her management team and conduct due diligence research on the market, the financial projections and other areas. For those opportunities that clear this investigation, VCs make an investment in exchange for equity ownership in the business. Venture capitalists also generally take a seat on the company’s board of directors and work side by side with the company founders to grow the business. In many cases, particularly in

the area of life sciences, the company founders are scientists with limited business experience. Therefore, the venture capitalists can play a crucial and complimentary role by helping to recruit talent, secure customers, implement budgets, and develop long term strategic plans. In other words, venture capitalists are not passive investors. In fact, many are scientists and technologists by trade and are therefore able to apply their technical *and* business experiences directly to the growth of the company.

Venture capitalists expect to hold a typical investment for 5 - 10 years, often longer in the area of life sciences, and rarely much less. During that time, VCs continue to invest additional capital into those companies that are performing well, and cease follow-on investments into companies that do not reach their agreed upon milestones.

The ultimate goal is described above -- an exit -- which is when the company is strong enough to either go public on a stock market exchange or become acquired by a strategic buyer at a price that ideally exceeds the investment. At that juncture, the venture capitalist “exits” the investment, though the business continues to grow. In recent years, the venture-backed acquisitions market has far exceeded the IPO market in terms of volume. This is especially true in the life sciences industry where larger corporate pharmaceutical companies have come to rely on the purchase of smaller venture-backed companies to support their R& D efforts.

Because at least one third of venture-backed companies ultimately fail, and those that succeed usually take 5-15 years to do so, there have historically been no other asset classes that have the long-term patience and fortitude to withstand the high risk nature of providing capital to these businesses. Commercial banks lack the appetite to invest in companies that have little or no collateral and such a high failure rate. Hedge funds and buyout shops typically balk at the long term nature of our investments and the required level of engagement in the company’s operations. Friends and family and angel groups have become more active in recent years – mostly in the technology sector, less in life sciences – but they do not have the capital necessary to take their companies all the way to a public offering or acquisition. Because of these dynamics, the venture industry has

been the only source of capital for many of these companies as they move through their life cycles.

It is important to recognize that despite the growing value created by venture capital, we remain a small industry that is actually shrinking still. In 2010, the venture industry invested just \$22 billion – representing less than 0.15 percent of GDP. We currently have approximately \$177 billion under management as an industry, compared to the buyout or private equity industry which manages approximately \$800 billion and the hedge fund industry which manages an estimated \$2 trillion. We estimate that there are about 790 venture capital firms in the U.S. of which 58 percent are actively making new investments. Our small investment goes a long, long way.

Contribution of Venture Capital to the US Economy

For the last four decades, the venture capital community has served as a founder and builder of companies, a creator of jobs, and a catalyst for innovation in the United States. This contribution has been achieved through high-risk, long-term investment of considerable time and dollars into small, emerging growth companies across the country and across industry sectors. According to a 2011 study conducted by econometrics firm Global Insight, companies that were started with venture capital since 1970 accounted for 12 million jobs and \$3.1 trillion in revenues in the United States in 2010. In doing so, our industry has collectively earned above average returns for our country's pre-eminent institutional investors and their beneficiaries including public pension funds, university scholarship endowments, and charitable foundations.

Venture capital has been behind such technology innovations as computer chips (Intel) search engines (Google), operating systems and routers (Microsoft and Cisco), hardware (Apple) online social media (Facebook and Twitter), and online retail and auctions (Amazon and eBay). We have also supported business model innovations such as superstores (Home Depot and Staples), quality food chains (Whole Foods), and coffee houses (Starbucks).

Within the last five years, the venture capital industry has committed itself to investing in the clean technology space, specifically renewable energy, sustainable materials and environmental innovations. Since 2006, the industry has invested nearly \$14 billion dollars in companies innovating in the areas of solar and wind power, electric cars, advanced battery technology, efficient energy grids and water purification. I can say with confidence that the clean tech economy of the future will be powered by venture capital.

Nowhere has the power of venture-backed innovation been felt more than in the life sciences sector. Approximately one third of all venture investment is directed into biotechnology and medical device start-up companies each year. After funding companies such as Genentech, Amgen, and Medtronic, the venture capital industry has helped bring life saving medical innovations to market over the last four decades. The results have been astounding. In 2010 alone, venture capitalists invested nearly \$6 billion into biotechnology and medical device start-ups. We estimate that more than 100 million Americans have been positively impacted by a venture-backed medical innovation.

Without venture capital, companies that have brought to patients medical devices such as the pacemaker, ultrasound, MRI, angioplasty and blood glucose monitoring and drugs such as Integrillin, ENBREL and Epogen would likely have never come into existence. At one time these lifesaving innovations were simply ideas put forth by scientists who had little experience in growing a business. The infusion of venture capital dollars and expertise moved their products to market and, in doing so, these companies created new markets that have made our lives healthier and more productive.

Despite popular belief that our industry only resides in Silicon Valley, venture capital is a national phenomenon with investment going to all 50 states. While certain regions of the country – such as Northern California and New England have successfully established thriving venture-backed communities, other areas such as Pennsylvania, New York, Colorado, Virginia and Minnesota continue to successfully support their own start-up ecosystems.

Political leaders in these states and others are seeking to do for their states what venture backed companies such as Dell have done for Austin or Medtronic for Minneapolis. The positive economic impact of a successful venture backed company headquartered in a region can be measured not only in jobs and revenues of *that* particular company but also by the spinouts of companies that inevitably emerge. A culture of entrepreneurship feeds on itself and can organically grow if the environment is properly nurtured.

Despite the value and economic strength created by venture capital investment, we are still a small and fragile industry. Our investing dynamics are highly susceptible to changes in our ecosystem. The one commonality for innovation and entrepreneurship to succeed is a consistent alignment of critical investment drivers including robust capital markets, access to talent, and a regulatory and tax environment that supports risk-taking and long term investment. Over the last several years, we have faced challenges -- both market and policy driven. But with these challenges comes opportunity to mitigate the uncertainty and continue to encourage long term investment in America's start-up companies.

Protecting the American Start-Up Economy and Innovation

Public policy plays a significant role in the health of the venture capital industry and in the companies in which the industry invests. Given the dynamic and evolutionary nature of our ecosystem, we need policies and programs that promote certainty, supporting and encouraging the formation and growth of companies that are innovating in a meaningful way. The following represents some of the most important ways that policymakers can help ensure our start-up ecosystem continues to prosper.

Encouraging Long Term Investment Through Tax Policy - NVCA has long advocated for a tax structure that fosters capital formation and rewards long-term, measured risk taking. We believe that the returns earned by venture capitalists and entrepreneurs as a result of building successful companies that are out-innovating others over the long term should be taxed at the capital gains rate. In recent years, this tax rate has been threatened

by those who do not understand the importance of encouraging venture investment. It is critical that the capital gains tax rate is globally competitive and preserves a meaningful differential from the ordinary income rate so that proper incentives remain for investors who are often dedicating more than a decade of capital and time to each of their companies. We appreciate the support of many members of Congress including Chairman Casey and Vice Chairman Brady in recognizing this dynamic.

To encourage truly long term investment, serious discussion regarding the holding period required to qualify for a long term capital gain should be made part of any upcoming debate on tax reform. The NVCA has been supportive of increasing the holding period generally for capital gains and also developing a tiered capital gains rate so that the longer an investment is held, the lower the tax rate on the ultimate gain. One area where a longer holding period would be helpful is in the capital markets where many investors are buying and selling shares of our venture-backed companies quickly. Offering capital gains tax incentives for investors to buy and hold public stock of small cap companies for longer periods of time will help encourage investment in our companies once they go public, increasing the appeal of an IPO.

Ironically, although the R&D tax credit is important to many mid-size and large corporations – many of whom are venture “graduates” – it is not a critical component of tax policy for start-ups that are still in the venture fold. Companies receiving current venture support generally are losing money – which is why banks and other traditional sources of finance find them too risky – and thus cannot use a tax credit that is structured for companies that are profitable. As lawmakers consider broad-scale tax reform to create a simpler, fairer tax code, the NVCA urges both Congress and the Administration to build a system that supports small companies and their investors as well as those that address the concerns of large, multinational corporations.

Protecting Sources of Future Capital - As previously stated, venture capitalists receive more than 90 percent of their money from institutional investors who commit a small percentage of their portfolio to alternative assets of which VC is but one. These investors

typically enjoy above average returns in exchange for the risk factors associated with venture investing. We estimate that public and private pension funds represent approximately 40 percent of the institutional investor base for venture capital, making this investor group the largest overall for the venture industry. The share is significant to the future of our industry as we are beginning to see a movement from defined benefit to defined contribution pension plans, particularly at the state and local level. If this shift continues in a meaningful way, the venture industry will be at risk for losing a critical source of capital as there is currently no viable means by which a defined contribution plan can invest in our asset class.

In 1978 Congress and the Department of Labor worked with the then fledging venture community to develop rules which permitted defined benefit pension plans to take part in venture capital. The result was the beginning of the American venture capital process we know today. Not since that time has the issue of institutional investor pools been more important to the future of the venture industry, and we hope to work together to develop some viable solutions to this looming concern over the next several years.

Encouraging More Small Cap IPOs - Studies show that more than 90 percent of job creation occurs after a venture-backed company goes public. In the last decade, however, the market for venture-backed initial public offerings (IPOs) has suffered due to unfavorable market conditions and ramifications from one-size fits all regulations. From Sarbanes Oxley (SOX) to the Global Settlement to Reg FD, regulations intended for larger multinational corporations have raised burdensome obstacles and compliance costs for start-ups trying to enter the public markets. From 2008 - 2010, only 62 venture backed companies have gone public compared to the same time period one decade ago when 583 companies had IPOs. At the same time, venture-backed acquisitions have been taking place in record numbers. While venture capitalists can return money from an acquisition, the IPO is the exit which translates into job creation for the U.S. Imagine if instead of going public, Genentech was acquired by Johnson & Johnson. While one would hope that the innovation would prevail, the job creation that would have inevitably

been quashed in the consolidation is almost unimaginable. The IPO dearth must be addressed or we face serious economic risks for our country.

The NVCA is actively engaging with Congress, the Administration and regulators on ways in which we can make the path to an IPO once again smoother, particularly for small cap companies. We feel there is an appetite for regulatory right-sizing so that our capital markets can once again be a viable – and preferred – exit for venture-backed companies.

Implementing Health Reform that Promotes Innovation – Improving the quality of care and fostering the advancement of innovation that improves the efficiency and cost-effectiveness of healthcare delivery are critical pieces to venture capital investment and our health care system. While not the focus of today’s hearing, we do have concerns regarding the medical device excise tax as well as the Medicare capital gains tax and the potential impact of those measures on our portfolio companies and our industry. As the law is implemented, we hope that all Members of Congress will remain open to hearing from our industry on those issues.

Other elements of the health care reform law, such as the increased emphasis on comparative effectiveness (CER), have the potential to improve patient outcomes and increase the efficiency with which our system delivers them. However, it is essential that CER be undertaken with the proper focus and context, to ensure that CER does not create undue hurdles for innovative new drugs and technologies.

Similarly, we are concerned that the Independent Payment Advisory Board (IPAB) has the potential to be an unbalanced regulatory authority that could stifle advances in medical innovation and hobble free market competition. NVCA believes that to be effective, entities such as the IPAB and the CER must include persons with deep expertise in medical technology innovation. These members would serve as needed advocates for innovation, ensuring that attempts to cut costs are balanced by an understanding of both the benefits of innovation and the potential impact that certain

reforms may have on the future of medical innovation in our country. This will ensure a proper balance between saving money, continuing to invent life-saving treatments for the future, and continuing to allow patient access to innovative technologies and therapies.

Supporting Broad Based FDA Reform - Just as one size fits all regulation has impacted the public stock markets, so too has it impacted medical innovation. The Food and Drug Administration (FDA) is one of the most influential government agencies in the United States, regulating 25% of the products in the domestic economy and impacting millions of patients each year. In recent years, when evaluating new drugs and medical technologies, the FDA has become increasingly reticent to balance the benefits against the risks of new therapies and technologies for seriously ill patients. In many cases, the evidence demanded to support approval has become unnecessarily extensive and cumbersome, deterring investment in innovative therapies and technologies for serious diseases. This is particularly troubling in areas where there are unmet medical needs and is resulting in less and later access to life-saving products when compared to other countries. Moreover, the regulatory burden is having a negative impact on job creation and is threatening our country's leadership in life sciences innovation.

Within the last year, our organization has formed the Medical Innovation and Competitiveness Coalition (MedIC) which comprises both venture capital firms and companies operating in the life sciences arena. The mission of the coalition is to advocate for policies that improve certainty and transparency within the FDA approval process which will in turn, encourage investment in life sciences companies. Specifically, we are calling for FDA reform that returns the balance to the review and approval process, ensuring seriously ill patients access to breakthrough therapies and technologies in a timely fashion. The regulatory assessment of benefit and risk should reflect the importance that patients and healthcare providers place on access to new products in the United States.

NVCA MedIC will be asking Congress to enact a set of focused and targeted policies that would restore the balance of patient benefits and risks in FDA decision-making, reform

the regulation of innovative technologies, hold the Agency more accountable to patients, healthcare providers, and sponsors, and strengthen the FDA's role in the innovation economy to restore US competitiveness. A copy of our priorities in this regard is attached as addendum A.

Also, it should be stated for the record that the NVCA understands that these reform measures require an FDA that is adequately funded. While the 2011 fiscal budget largely spared the FDA from significant cuts, we have concerns regarding future cuts in the 2012 budget. While all agencies should root out waste and duplication, untempered resource reduction at the FDA will result in a reduction in innovation being delivered to the American people. We ask that Congress be mindful of the trade-off here.

Filling the R&D Pipeline - Maintaining America's global innovation advantage requires continued federal funding for basic research and development. Discoveries in federal labs and universities remain the germination points for the breakthrough ideas that can be commercialized by entrepreneurs and venture investors and transformed into the promising new companies that will drive job creation and economic growth. This unique public-private partnership has delivered countless innovations to the American public and a decisive competitive advantage to the U.S. economy for decades. Yet recently, fiscal realities have threatened the funding levels for basic research grants in such areas as life sciences and energy. We understand the need for fiscal responsibility, but drastically reducing the funding those types of companies that can participate will be devastating long term to our global economic leadership. As Congress reviews ways to cut spending and balance the budget, we urge lawmakers to take a longer term approach and protect those areas that are innovating for the future.

Further, we remain extremely disappointed regarding the once again stalled SBIR Reauthorization bill. The ongoing lack of clarification regarding whether venture backed companies can apply for government grants (such as SBIR grants) to conduct early stage research has unquestionably hurt the innovation pipeline. We hope that another year does

not go by in which the most promising, innovative projects are not eligible to receive SBIR grants and subsequently die on the vine.

Embarking Upon Legal Immigration Reform - The U.S. must continue to attract and retain the world's best and brightest minds if it wants to maintain its global economic leadership. However, a number of factors have hindered our ability to keep foreign born entrepreneurs here in the US. The first is that developing countries such as India and China have been hard at work over the last decade growing their own start-up ecosystems that today rival the US market. In many cases they are offering tax and other incentives for entrepreneurs to form their companies on their shores. Foreign born entrepreneurs now have a number of good choices in terms of where they start their businesses. Second, and more importantly, it has been increasingly difficult for these foreign born entrepreneurs to come to the US and build their companies here due to our immigration policies. Even students who have studied at the best American universities are finding it difficult to remain and innovate here. We estimate that 25 percent of the largest venture-backed companies that today are thriving public entities were founded by one or more foreign born nationals. Unless our government is able to reform our legal immigration policies, we remain at high risk for losing these innovators to other countries.

For this reason, NVCA supports policies that allow foreign-born entrepreneurs to come to America to build their companies and create U.S. jobs. Proposals such as the Start-Up Visa Act will allow enterprising professionals to come here to develop their ideas and then remain here to build their companies, as opposed to innovating and creating economic value overseas. Further, the NVCA supports a streamlining of the pathway to “green cards” for foreign born graduate students who wish to remain in the United States upon completion of their studies.

Protecting Small Innovators and Inventors with Patent Reform - We continue to have significant concerns regarding the patent reform legislation that has passed the Senate and which is currently being taken up in the House. While we strongly support the provisions that would end the diversion of fees from the patent office, giving examiners critical

resources, we remain concerned that other sections of the bill may not adequately protect small innovators. Small venture-backed companies use every dollar for research, product development and scaling their enterprise. They do not have the deep reserves necessary to protect themselves from large companies that infringe on their patents or that may use some of the new procedures in the legislation, such as post grant review, as a harassment tool. We will continue to work with Congress to amend the current bill to help these small companies as the implications for investment in this sector are significant.

Conclusion

In many ways America is at a cross roads when it comes to enacting policies that support start-ups' job growth and innovation across all industry sectors, including the life sciences industry. Market forces have challenged the US venture capital industry over the last several years while foreign countries grown their own ecosystems at a rapid pace. At the same time, the regulatory restrictions placed upon those companies that are innovating in meaningful ways have weighed down the growth trajectory these start-ups once enjoyed. Our global leadership in innovation can no longer be taken for granted; in fact we are at risk for losing it in certain areas if we do not address the challenges that we face.

The opportunity remains to encourage long term investment in start-up companies through smart and fiscally sound tax policy. The regulatory environment can be right-sized and adjusted to ensure that the best companies are able to bring their most innovative products to market and thrive in our country's capital markets system. And policies can be enacted so that the best and brightest minds can build their businesses in the US and the best and brightest breakthroughs can be funded in their earliest stages. If we take the proper paths here, there is no doubt that innovation will prevail. We appreciate your willingness to better understand our industry and its key drivers so the path towards growth and protecting innovation will indeed be taken.

The venture capital industry remains committed to long term investment in our country's future. We look forward to working with Congress to ensure that our companies continue to grow and create significant economic value for years to come.