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**REPORT TO SECRETARY LOCKE  
IMPROVING ACCESS TO CAPITAL  
FOR HIGH-GROWTH COMPANIES**

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**Department of Commerce**  
National Advisory Council on  
Innovation and Entrepreneurship

June 2011







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National Advisory Council on  
Innovation and Entrepreneurship



## About the National Advisory Council on Innovation and Entrepreneurship

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The National Advisory Council on Innovation and Entrepreneurship (NACIE) is comprised of leading entrepreneurs, innovators, investors, university and economic development leaders. It is charged by the Secretary of Commerce to identify ways in which the United States may remain a source of paradigm-changing innovation and home to the companies that take them to market. NACIE offers policy recommendations to facilitate economic growth through entrepreneurial activity, the commercialization of new ideas into high-growth businesses, and job creation. NACIE is supported by the Department of Commerce's Office of Innovation and Entrepreneurship (OIE).

For more information about NACIE, see <http://www.eda.gov/NACIE>



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### NATIONAL ADVISORY COUNCIL ON INNOVATION AND ENTREPRENEURSHIP

Secretary Gary Locke  
U.S. Department of Commerce  
Washington, D.C. 20230

Dear Mr. Secretary,

As co-chairs of the National Advisory Council on Innovation and Entrepreneurship, and on behalf of the full membership, we are pleased to submit to you our Report, *Improving Access to Capital for High-Growth Companies*.

This Report grew out of discussions with you at our September and December 2010 meetings, where you requested we identify the most pressing issues confronting entrepreneurs and high-growth companies across the United States. High-growth companies fuel America's innovation economy and generate 40% of new jobs every year, yet have have faced considerable economic and regulatory hurdles over the past decade, especially with respect to attracting early-stage investments and accessing later-stage public markets. As a Council, we agreed to devote attention to studying and recommending policy changes that can improve early and growth-stage access to capital.

In the following report, we offer eight policy recommendations. To improve early-stage access to capital, we propose the Administration consider offering refundable tax credits for angel group investments, as well as tax exclusions on small business capital gains and corporate income taxes to relieve startup operating constraints. We also recommend further reductions in SBIR/STIR process lead times and support for the SBA's newly announced Early-Stage Innovation Fund. To facilitate later stages of growth, we recommend the extension of current capital gains tax rates on venture investments and changes that will decrease regulatory burdens associated with the Spitzer Decree and Sarbanes-Oxley Act.

We believe collective implementation of this limited set of recommendations can accelerate high-growth entrepreneurship, thereby increasing domestic job creation and economic growth, and ultimately contributing to America's global competitiveness.

Sincerely,

**Steve Case**  
NACIE Co-Chair

**Dr. Mary Sue Coleman**  
NACIE Co-Chair

**Dr. Gururaj Deshpande**  
NACIE Co-Chair





## Executive Summary

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Entrepreneurship plays an important role in American history as one of the key drivers of our economic growth and stability. From Google and GE to Amgen and Whole Foods, high-growth companies have revolutionized global industries in electronics, energy, health, food, consumer goods, and countless other markets. They have leveraged American ingenuity towards the creation of domestic platforms and innovation ecosystems, while contributing to over 40% of new American jobs every year.

Yet in the wake of recent economic challenges, entrepreneurs in high-growth companies have found their access to capital significantly constrained. Investment in startup and early-stage companies has steadily declined since the dot-com crash, compounding the typical challenges high-growth startups face with operating capital. Concurrently, later-stage firms' access to funds through the public markets has been curtailed due to the unintended consequences of legal and regulatory actions taken to protect investors and limit fraud such as the Spitzer Decree and the 2002 Sarbanes-Oxley Act. If America wants to maintain its global leadership in entrepreneurial talent, companies, and innovation, it must take steps to address these challenges, and reduce barriers limiting high-growth firms' access to capital.

In December 2010, Secretary Locke asked the National Advisory Council on Innovation and Entrepreneurship (NACIE) to study the legal and regulatory impediments to capital access and identify ways in which the Obama Administration could improve and accelerate access to capital for high-growth companies. Over the past several months, we have consulted numerous stakeholders, including entrepreneurs, business angels, venture capitalists, researchers, and regulators to better understand factors constraining access to capital, as well as potential solutions. This report encapsulates our findings and presents a set of actionable policy recommendations that we believe, if implemented collectively rather than selectively, will address major factors limiting high-growth companies' access to capital.

To improve access to capital for early-stage high-growth companies, we recommend a series of measures that can mitigate seed and startup investment risk while leading to an increase in the overall pool of available capital. Specific proposals include a refundable tax credit on angel group investments in qualified small businesses to help incentivize private-capital investments, as well as short-term tax exclusions on capital gains or corporate income taxes to relieve startup operating

capital constraints. Other recommendations focus on improving existing federal programs to match early-stage capital needs, such as hastening the SBIR/STTR grant review process and reducing the interest rate burden on early-stage SBIC-portfolio companies through an Early-Stage Innovation Fund.

For later-stage access to capital, we recommend the Administration address a series of regulatory hurdles that constrain the expansion of high-growth companies. We encourage the Administration to permanently set the capital gains tax rate at its current level, which will maintain investor liquidity incentives. We recommend amending the Spitzer Decree to permit a modified mechanism for investment banks to provide investors with expanded information about publicly traded companies. We also propose improvements to the Sarbanes-Oxley legislation that may reduce the financial control burden on smaller public companies while providing the desired level of safe guards for investors. Collectively, these changes will ease high-growth company access to public markets by reducing barriers to the use of initial public offerings as a tool for accessing growth capital.

### **NACIE Recommendations**

#### **Recommendations for Early-Stage Access to Capital**

- 1: Provide a 30% refundable tax credit on angel group investments of <\$200,000 into small businesses.
- 2: Provide a 100% exclusion on capital gains tax to small business investments held for 5 years, with deferrals permitted for roll-over investments into other small business within 9-month periods.
- 3: Provide a 100% exclusion on corporate income tax for the first taxable year of profit, a 50% exclusion on following two years of profit, and tax deferral on exercise of NQ stock options in small businesses.
- 4: Reduce further the SBIR/STTR grant review process from the current 6-12 months to a 3-month timeframe.
- 5: Support the SBA's proposed Early Stage Innovation Fund and efforts to further reduce SBIC license processing times and interest rate burden. Recommend future SBIC eligibility consideration be given to emerging investment classes such as angel groups, micro-VCs, and VDOs.

#### **Recommendations for Later-Stage Access to Capital**

- 6: Maintain the capital gains tax rate at 15%.
- 7: Amend the Spitzer Decree to permit payment for analyst coverage through banking revenue, and mandate analyst coverage of IPO issuers for at least five years.
- 8: Amend Sarbanes-Oxley Act Section 404 to reduce compliance controls and external-audit frequency on smaller public companies.



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National Advisory Council on  
Innovation and Entrepreneurship





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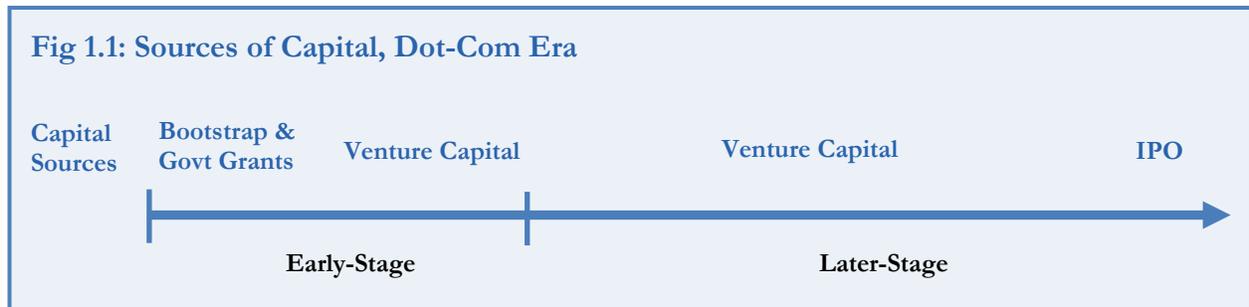
# 1. High-Growth Companies and the Economy

High-growth companies have historically played a key role in technological innovation and job creation in the United States.<sup>1</sup> Firms such as Amgen, General Electric, Google, and Whole Foods were all started in the United States [1], but went on to revolutionize global industries in health, energy, electronics, and consumer goods. Such firms have catalyzed paradigm shifts, created entirely new markets, and inspired radically new products and services. High-growth companies like Facebook have even provided a platform for innovative job-creating startups like Groupon and Zynga. Unsurprisingly, 40 percent of new job creation is concentrated in the top 1 percent of high-growth companies every year [2].

Yet in the wake of recent economic challenges, entrepreneurs, startups, and high-growth firms have found their access to capital significantly constrained, with over 70 percent of firms citing financial woes and concerns [3]. To facilitate private sector job creation, majority of which is generated by high-growth enterprises, it is incumbent upon our leadership to reduce barriers to firm creation and accelerate their growth [2]. Pursuant to accomplishing this goal, the National Advisory Council on Innovation and Entrepreneurship (NACIE) has focused its attention on the changing ability of high-growth companies to access risk capital.

## 1.1 High-Growth Companies: Dot-Com Era

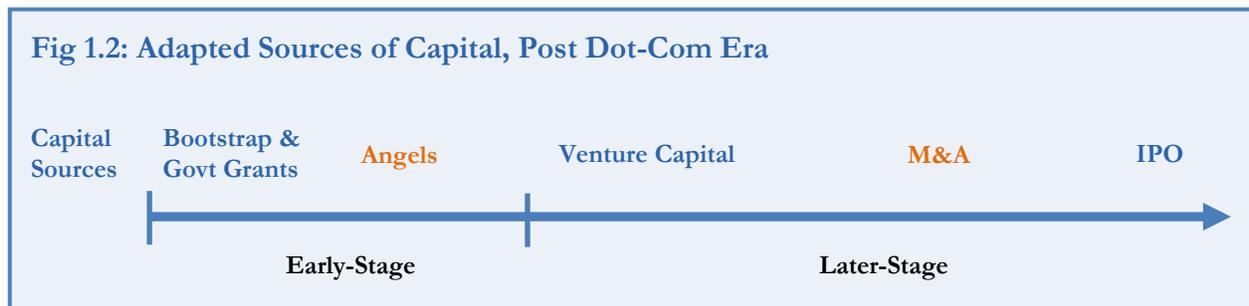
From NACIE’s perspective, high-growth companies’ ability to access capital has undergone significant changes over the past decades. During the 1990s, dot-com and IT companies faced a steady stream of available capital (see Fig 1.1 below) given relatively low barriers to entry and a bullish economy.



<sup>1</sup> For the purposes of this Report, we have qualified the term of “high-growth” to companies with a prospective 20% annual employee growth rate, and a minimum of 10 employees.

In the early-stages of development, firms could bootstrap funds and credit while working within a supply of non-dilutive government funding towards early product development. As they proved out concepts and gained market traction, early and later-stage firms could seek out a rising tide of Venture Capital (VC) funds— fueling their expansion and helping raise large sums of money through initial public offerings (IPOs). Firms could further use the proceeds to finance job creation, while their VC backers could raise ever-increasing funds from Limited Partners (LP) based on rapid exits and high returns on investment (ROI) [4].<sup>2</sup>

From 2000-2002 however, as capital flows changed in response to the dot-com bubble burst, high-growth firms were forced to adapt. The role of VCs shrank as their internet/IT based funds saw declining LP returns, VC-backed exits fell from 264 to 24 IPOs, and early-stage VC investments dropped from 2,874 to 880 deals in just 2 years [4 - 6]. High-growth firms were consequently forced to adapt, seeking out serial entrepreneurs and business angels who could invest their personal wealth into early-stage startups (see Fig 1.2 below). Later-stage firms relied more heavily upon mergers and acquisitions (M&A) as a source of liquidity, given the gap in available IPOs and increased revenue requirements of emerging life science and clean-tech sectors. By the mid-2000s, these new funding sources had respectively stabilized high-growth firms for the short-term, but at a reduced level.

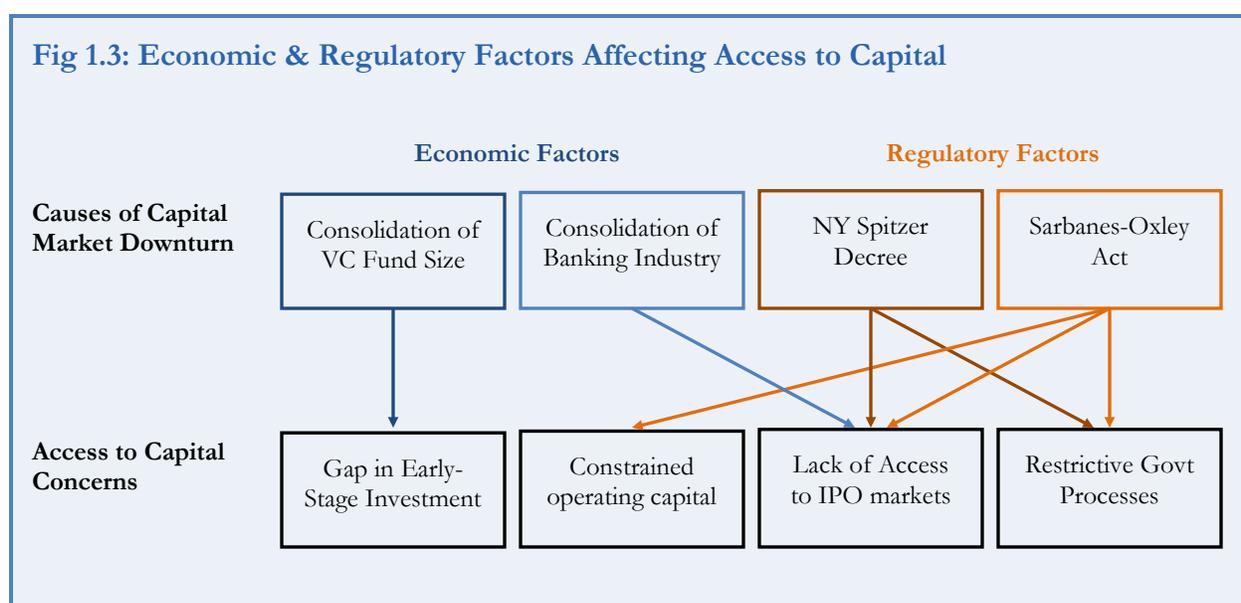


## 1.2 High-Growth Companies: Credit-Crunch Era

Unfortunately for high-growth firms and investors alike, the post dot-com adaptations were cut dramatically short by the housing and credit crises of 2007. While the bursting of the internet bubble introduced significant friction into capital markets, the housing and credit crises completely froze them. Traditional sources of bootstrapping funds, like credit cards and home equity leverage dried up. LP returns in VC funds depreciated further, venture capitalist numbers cut in half, and VC groups synthesized into larger funds uncondusive to smaller early-stage deals [7]. Later-stage capital

<sup>2</sup> Figures 1.1 and 1.2 are meant for heuristic purposes, and are not necessarily to scale or universal to all firm lifecycles.

suffered further, as the investment banking sector that traditionally supported IPOs began to consolidate—detering public market focus in favor of decimalized assets. The average time to exit by IPO or M&A consequently increased from 4.5 years in 1998 to 9.6 years in 2008, as emerging foreign IPO markets and increased asset decimalization reduced incentives for later-stage support of domestic high-growth companies [4]. Adding in existing regulatory overhauls to compound the new gaps in capital (see Fig 1.3 below), regulatory factors such as the Sarbanes Oxley Act and NY Spitzer Decree even raised the barriers to public market liquidity during the credit crunch through increased financial controls and prohibitions on paying for firm research through banking revenue, respectively [8, 9].



The result of these trends is several widening gaps in access to capital for high-growth firms. From limited funds for bootstrapping to the perception that firms are locked out of the IPO market, high-growth companies face dramatic challenges in raising capital. While some of these challenges have been mitigated by recent increases in the availability of risk capital primarily for IT companies in Silicon Valley and Boston, wider geographic and sector-based challenges remain. As a result, high-growth companies can be seen to face four primary challenges when accessing capital:

1. **Gaps in early-stage investments**
2. **Constrained startup operating capital**
3. **Lack of access to later-stage IPO markets, and**
4. **Restrictive or inefficient federal government processes**

### 1.3 Improving Access to Capital for High-Growth Companies

It is in the wake of this reality that we believe the federal government must make changes to the legal and regulatory environment to foster greater access to capital for high-growth companies.

The Obama Administration has already taken and proposed several steps to address these issues. We commend the Administration for launching Startup America, which is helping to accelerate high-growth entrepreneurship. We support the President's proposal to make permanent a 100% exclusion from capitals gains tax on small business stock that can reduce the risk of early-stage investments [10]. The Small Business Administration (SBA) has also announced two separate \$1 billion funds to match private-sector investments in underserved or early-stage ventures, which we believe can bridge the gap in startup operating capital.

Moving forward, NACIE hopes such initiatives can serve as a platform for comprehensively addressing both early-stage and later-stage access to capital concerns. The government has a set of underutilized policy levers still at its discretion, including refundable credits, tax reductions, and federal grant processes that we believe can further assist in bridging the capital gap. NACIE offers this Report to help develop such a set of comprehensive policy recommendations, with the firm aim of accelerating high-growth entrepreneurship while avoiding another dot-com bubble. Accordingly, our goals can be stated as:

- 1. Bolstering access to capital through the private and public markets**
- 2. Providing policy levers applicable to different startup lifecycles and industries, and**
- 3. Enhancing a rate of sustainable firm growth and US job creation**

In the following chapters, we propose eight policy recommendations, which were developed with input from entrepreneurs, business angels, venture capitalists, and other key stakeholders, to meet such objectives. In Chapter 2, we will focus on tax and federal grant processes that can reduce the risks associated with early-stage investing. In Chapter 3, we propose amendments to existing government regulations to help ease the barriers on later-stage access to capital. For study beyond this Report, we also encourage a holistic review of existing government processes related to matching industry-capital needs, hastening bill-repayment to startups within 30 days, and addressing unmet needs of non-profit VDOs in matching CRA investment standards. We also recommend review of accredited investor rules within SEC Regulations A and D, as well as foreign income repatriation policies, to address some of the later-stage capital concerns of high-growth companies.

To improve access to the public markets, we recommend the SEC review and approve the NASDAQ OMX BX-Venture Market, which has the potential to facilitate the ability of smaller public companies to raise capital and expand their businesses.

In conclusion, many people may point to America's ability not only to germinate innovative new companies, but to encourage and facilitate a constant flow of high-growth companies that eventually become "billion dollar firms". There is even research that suggests doubling the number of high-growth firms that generate \$1 billion in annual revenue will not only accelerate the rate of job creation, but actually add one percent to the United States' GDP [11].<sup>3</sup> Taken together, we believe collective implementation of this limited set of recommendations can accelerate high-growth entrepreneurship, spur the formation of more billion-dollar firms, increase domestic job creation and economic growth, and ultimately contribute to America's global competitiveness.

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<sup>3</sup> A 2010 study noted that if the number of new billion-dollar firms increased to an average of 30-60 every year, the US economy could grow at 4 percent annually instead of 3 percent, and GDP could double six years faster [11].

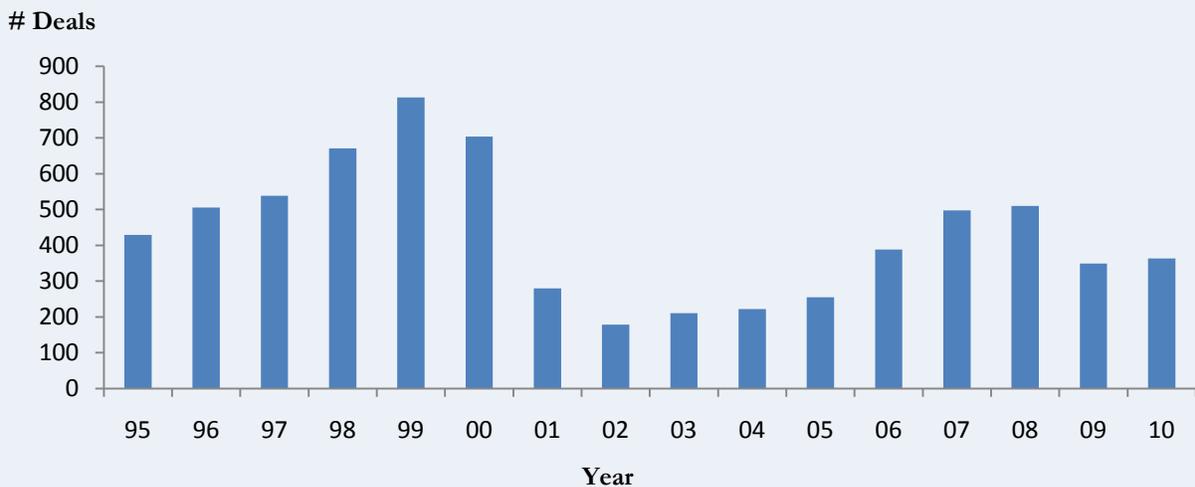




## 2. Early-Stage Access to Capital

Ensuring a necessary and sufficient supply of early-stage capital to high-growth companies is one of the greatest challenges to startup growth. As noted in Chapter 1.1, early-stage VC investments have fallen significantly since the dot-com crash, leaving a gap in the supply of startup capital for high-growth companies (see Fig 2.1 below). While the decline brought available VC capital more inline with pre dot-com bubble levels, it left early-stage deal flow susceptible to additional market shocks, and increased VC focus on lower risk, later-stage deals. And despite the recent uptick in risk capital, modest increases have been concentrated in the Silicon Valley and Boston clusters. As such, NACIE encourages the Administration to provide additional incentives that can responsibly mitigate seed-investment risk and encourage early-stage access to capital across all regional clusters. We offer several incentives in the following recommendations, while working to avoid the pitfalls of another dot-com bubble.

**Figure 2.1: Decline in Seed-Stage VC deals [6]**



### 2.1 Tax Incentives for Seed-Stage Business Investments

One mechanism the Administration should consider to improve the overall pool of seed-stage capital is greater support for the emerging class of business angels. Angels, as described in Chapter 1.1, are serial entrepreneurs who utilize their own capital to invest in proof-of-concept and startup opportunities. Their investments usually range from \$25,000 - \$100,000 and are regionally concentrated but often distributed across a number of sectors, helping meet local seed investment needs unmet by venture capitalists [12]. Yet as VCs invest from capital pools of tens to hundreds of

millions of dollars and operate on deal flows of 5 to 50 investments a year, business angels can usually only make a single to couple dozen investments per year given their personal risk tolerances, return goals, and constrained capital pools.

Based on early-stage needs and investor demands, the Administration should take steps to ensure that the risk and reward system confronting business angels contains sufficient incentives for them to both collaborate more frequently and accelerate their investments in startup opportunities; helping supplant the early-stage gap left by VC investments.

### **Recommendation 1: Refundable Tax Credits for Individual Angel Investments**

The Administration should propose a 30% refundable tax credit to members of accredited angel groups for investments into US-based startups. The credit would apply to investments of up to \$200,000 in a Qualified Small Business (less than \$50 million valuation at time of investment), and refunded within the first fiscal year the investment was made.

Evidence from comparable programs indicates that providing a refundable tax credit to members of accredited angel groups (with accreditation terms to be defined by the Angel Capital Association) could appreciably improve the rate of angel investing in seed-stage startups. British Columbia (B.C.) implemented a similar program several years ago and has since seen measurable success. A 2010 study noted that 80% of B.C. angel investors who received the credits had increased the amount of their investments [13]. B.C. company revenues had even been seen to grow on an average of \$572,000 a year after the initiative was launched, and many companies recorded an average increase of 2.43 jobs a year [14]. **Most importantly, the initiative had resulted in a net gain for the taxpayer, with every \$1 of angel tax credits resulting in \$1.41 of additional B.C. tax revenue from the recipient companies.**

As proposed for the United States above, business angels could comparably see 30% of their annual investment returned as a tax credit the following year, thereby reducing their risk portfolio and freeing up capital to make increased investments into high-growth firms. Business angels who operate across regions and sectors would be so incentivized to invest as accredited groups rather than as individuals, with the expectation that these groups would perform greater due diligence on prospective investments. High-growth firms will consequently face reduced risk in startup operating capital, and see an increase in access to capital beyond just the Silicon Valley and Boston clusters.

*\*This recommendation will require legislative action and falls under the purview of the Dept of Treasury\**

## 2.2 Capital Gains Incentives for Early-Stage Business Investments

The Administration also should consider revisions to the capital gains tax structure to address the gap in early-stage investments. According to the current tax code, capital gains accruing to business angels and VC funds should be taxed at 15 percent. The 2010 Small Business Jobs Act temporarily exempted 100 percent of an investor's capital gains on investments held for at least 5 years in Qualified Small Businesses (QSB), under Section 1202 of the Internal Revenue Code (IRC). President Obama has called for this exemption to be made permanent, rather than allow it to expire after December 31, 2011. NACIE endorses the President's position, with minor revision for extending the rollover period on QSB capital gains from 60 days to 9 months.

### **Recommendation 2: Extension of the Capital Gains Exclusion and Rollover Periods**

The Administration should continue its support of a proposed permanent exclusion on capital gains tax on invested capital under IRC Sec 1202, limited to investments held for at least 5 years in a Qualified Small Business (less than \$50 million valuation at time of investment) with its exclusion as an Alternative Minimum tax preference item. Additionally, IRC Sec 1045 should be amended to extend the permitted rollover period on QSB capital gains from 60 days to 9 months

Permanently reducing the capital gains tax rate on investments in qualifying small business stock under IRC Sec 1202 will have a significant positive impact on rates of return to Limited Partners, a consequent reduction in investor risk, and a provision of more capital to be rolled over into subsequent investments in small and early-stage companies.

Furthermore, extending the rollover period on capital gains under IRC Sec 1045 could incentivize even greater re-investment into early-stage QSBs. Under the current law, capital gains from a QSB investment sold before the 5-year holding period can still be deferred from tax if reinvested into a similar business within 60 days of sale. This 60-day limit is impractical however, considering the lengthy due diligence and terms negotiation required for investments, and the fact that closing dates for multi-investor deals are often out of a single investor's hands. NACIE therefore recommends that the rollover period be extended to a 9-month limit to make the provision more actionable. Such policies may in turn increase the likelihood of early-stage investments and rollover stakes, driving business angels and VC firms to direct their capital into high-growth startups instead of larger assets.

*\*This recommendation will require legislative action and falls under the purview of the Dept of Treasury\**

### 2.3 Tax Incentives for Startup Operating Capital

Equally strong levers for improving startup operating capital may come through revisions to the corporate tax burden on newly profitable companies, and through tax incentives for startup employee retention. As mentioned in Chapter 1, current market conditions have forced over half the firms in a 2010 study to express concern for declining sales or unmet growth objectives, with existing tax commitments limiting potential firm growth [3]. Corporate tax burdens on newly profitable firms have drawn much needed capital away from internal reinvestment just as these firms “turn the corner,” and considerably impacted life science and clean-tech firm profitability considering their extended gestation periods. Comparably, startup employees compensated with NQ stock options in such firms have often incurred tax liabilities just before their options can be exercised, placing undue financial burden on employees, leading to increased employee turnover, and adding strain on startup resources.

NACIE recommends a short-term exemption on the first years of high-growth company profits, as well as a tax deferral on employee NQ options to improve the growth potential of early-stage firms.

#### **Recommendation 3: Short-Term Exclusion/Deferrals on Corporate Tax & NQ Options**

The Administration should propose a 100% exclusion on corporate income tax for qualified small businesses on their first taxable year of profit (after use of any Net Operating Losses), and a 50% exclusion on the following 2 years of profit. Deferral for employee taxes on exercise of NQ stock options in QSBs is also requested to match ISO-like incentives.

These early exclusions on corporate tax revenue at a critical juncture in firm growth have the potential to increase the amount of growth capital available for reinvestment, while reducing the need for additional rounds of external financing. At the same time, offering employees of qualified small businesses a tax deferral on NQ stock options could reduce employee turnover, while preserving institutional knowledge and lessening process and product lead times. Life science and clean-tech firms that specifically experience long periods of cash burn and little revenue may be better stabilized for stronger margins and employee incentives under such exclusions. Increased profitability ultimately serves to increase liquidity incentives for available early-stage capital to such firms, and help stabilize firm growth amidst a changing economy.

*\*This recommendation will require legislative action and falls under the purview of the Dept of Treasury\**

## 2.4 Review of Federal Grant Approval Processes

To further enhance access to capital for high-growth startups, NACIE proposes a review of the existing Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) programs. The SBIR and STTR initiatives currently offer startups access to R&D capital through a set of federally funded grants. Grants are provided through 11 different federal agencies including the DOD, DOE, and NIH, helping fill the early-stage capital gap by over \$1 billion a year. Several NACIE members have personally used SBIR/STTRs in past ventures, and can attest to the program's capacity to assist early-stage firms and angel investors in reducing the risk of investment through a non-dilutive framework. However, our experience is not unlike that of most SBIR/STTR awardees, in that lead times for approval have ranged from six to twelve months, depending on the funding agency. Such lead times are at best an annoyance to high-growth startups, which face incredible capital constraints and limited human resource capacity to track and monitor grant applications. For the approximately 20 percent of startups that close within a year of initiating business operations, and the majority of ventures that operate on tumultuous quarterly cycles, a 12 month-approval process can spell unnecessary disaster [2].

NACIE recommends that every effort be made to shorten the approval process, including potentially mandating a maximum time allowance.

### **Recommendation 4: Hastening of the SBIR / STTR Approval Timeline**

Federal agencies should reduce their standard SBIR and STTR approval timelines from a 6-12 month process to a 3-month timeframe. Acceleration of the approval process will ensure better matching to early-stage business cycle and capital needs.

NACIE leaves programmatic implementation of such a stretch goal to the respective federal agencies managing SBIR/STTR grant programs. We acknowledge the differences in federal agency review processes and resource constraints, and fully recognize that the agencies are better suited to informing specifics of an accelerated approval process. If agencies' due-diligence concerns necessitate a minimum 6-month review process, one alternative may be to establish rolling 6-month review processes, staggered by quarters, to give startups a 3-month application window. Either consideration could ultimately help better match the SBIR/STTR program to early-stage business cycles, and assist in filling the capital gap.

*\*This recommendation will require administrative action and falls under the purview of the respective SBIR / STTR agencies\**

## 2.5 SBA Early-Stage Innovation Fund

Our final recommendation for spurring increased early-stage investments relates to the SBA's recently announced Early-Stage Innovation Fund. A \$1 billion fund operating under the existing Small Business Investment Company (SBIC) platform, the initiative may prove to be a strong lever for encouraging private-sector investments at no additional cost to the taxpayer. The Fund will distribute debt capital through existing SBA-guaranteed bonds, matching SBIC-licensed venture funds 1:1 on equity or debt investments. By matching private sector capital, the Fund may mitigate the risk associated with early-stage venture investments, thereby increasing the amount of funding available to high-growth startups.

The new Fund also addresses concerns of early-stage investors and entrepreneurs unable to utilize the SBIC program in the past. Burdensome license processes and portfolio interest rate payment requirements have historically limited the SBIC's utility. Lengthy approval times deterred investors, while guaranteed bonds necessitated that many SBICs hold interest-bearing debt portfolios that proved difficult for investors in early-stage firms [15]. The SBA has sought to address these concerns with its new Fund by already reducing the approval processes from 14 to 6 months, and exploring interest rate payment reductions on SBIC portfolio companies.

### **Recommendation 5: Support for the SBIC Program to address Early-Stage Capital Needs**

We support the SBA's efforts to amend its existing SBIC program to better address startup capital needs through the proposed Early-Stage Innovation Fund. We encourage them to continue efforts to reduce lead SBIC-license approvals and interest rate burdens, with consideration to emerging investment classes in angel groups, micro-VCs, and VDOs for future SBIC eligibility.

NACIE applauds the SBA's continuing efforts to make the SBIC program more applicable to investors in early-stage firms. We encourage ongoing efforts to reduce approval lead times even further, possibly to as short as three months. This would facilitate participation in the SBIC program by smaller funds, micro-VCs, and VDOs that can support early-stage deals. We also encourage the SBA to consider changes that could encourage more participation by ever increasingly sophisticated business angel groups. Many of these groups have developed more mature investment practices, coalesced into more sophisticated entities with greater internal controls and entered into public-private partnerships suitable to early-stage companies. Finally, we encourage the SBA to

## EARLY-STAGE ACCESS TO CAPITAL

further consider how changes in interest payment requirements on SBIC portfolio companies can better equip early-stage cash-strapped firms to operate on matched debt capital. Implemented collectively, such measures could greatly incent private sector investments suitable to early-stage capital needs.

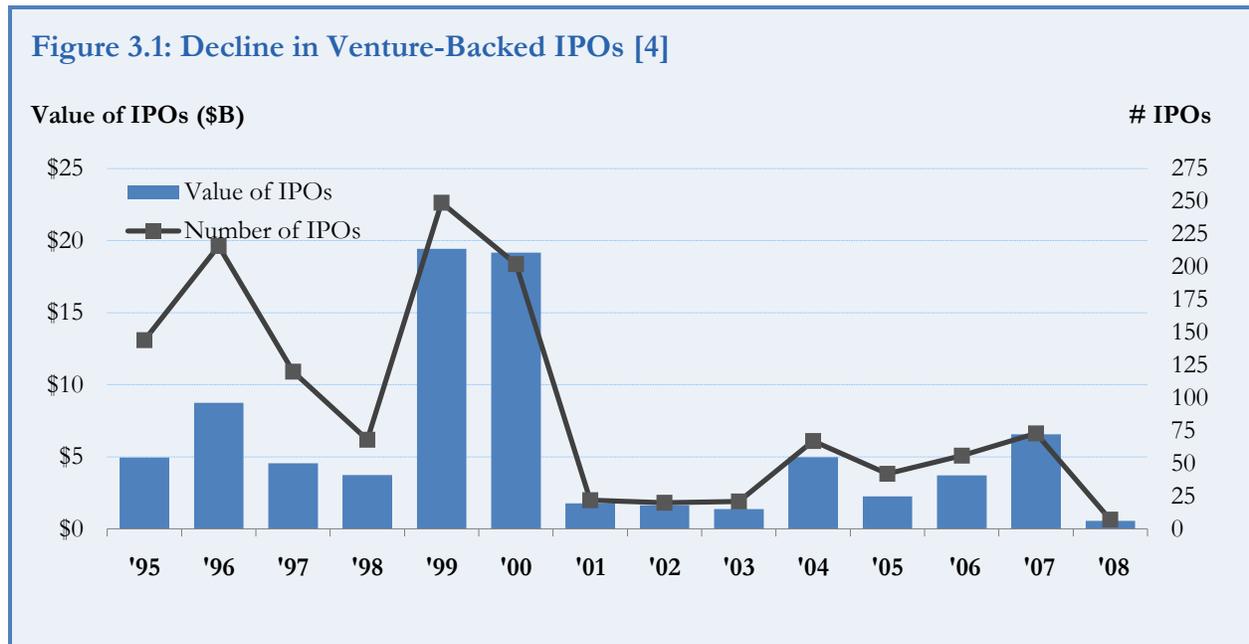
*\*This recommendation will require administrative action and falls under the purview of the SBA\**





### 3. Later-Stage Access to Capital

As high-growth companies transition from early to later stages of development, their ability to access growth capital has also seen significant strain. As discussed in Chapter 1.2, a slew of economic and regulatory factors have hindered the ability of later-stage firms to access financial resources, especially in public markets that were historically a leading source of capital for product development and market growth. As the dot-com bubble reduced economic incentives for investment activity, the Spitzer Decree and Sarbanes-Oxley regulations have compounded investor disincentives and largely constricted access to the public markets and IPOs (see Fig 3.1 below). NACIE recommends several changes to tax and regulatory policies to help alleviate such market dynamics and improve access to later-stage capital.



#### 3.1 Capital Gains Incentives for Later-Stage Business Investments

Preeminent among our recommendations is the continuation of current capital gains tax rates. Capital gains on investments held for more than one year are currently taxed at lower rates than ordinary income, with a 15% capital gains tax rate vs. an average 35% top marginal rate. Such rates keep investment margins high, with corresponding incentives in place for business angels, VCs, and public investors to make investments in high-growth firms instead of less risky bonds or assets.

This notwithstanding, there are a series of forthcoming revisions set to increase the capital gains tax rate and possibly hinder such incentives for startup investment. The extension of the Bush Tax Cuts, for one, will expire on December 31, 2012 and thereby raise the capital gains tax rate to 20%. The Patient Protection and Affordable Care Act (PPACA) will place an additional 3.8% tax on earned income (including capital gains), effectively raising the capital gains tax rate on business investments to 23.8% in 2013. When combined, these increases represent a 58% increase in the tax level from this year, thus warranting a meaningful review.

#### **Recommendation 6: Sustainment of Current Capital Gains Tax Level**

The Administration should commit to maintaining the current capital gains tax at 15%, or provide exclusion for capital invested in businesses from the respective 5% and 3.38% increases in earned-income tax under the Bush Tax Cut expiration and PPACA reforms.

Maintaining the capital gains tax at 15% will accordingly affect future incentives for later-stage investments. Given the increased risk associated with investments in high-growth firms, venture investors cannot afford further reductions to their return on investments [5]. A sustained 15% tax rate can ensure no further reductions in ROI for LPs of VC funds, and no consequent increase in difficulty for later-stage high-growth companies to access capital — thereby deterring a scenario of depreciating later-stage deals should the tax increases go into effect.

*\*This recommendation will require legislative action and falls under the purview of the Dept of Treasury\**

### **3.2 Regulatory Incentives for Public Market Analysis**

Among other possible policy levers to consider in improving later-stage access to capital, we recommend prioritizing steps to ease the regulatory barriers associated with the Spitzer Decree (see Chapter 1.2). Instituted through the New York State Attorney General's Global Research Settlement in 2003, the Decree has mandated investment banks to separate their investment and research divisions so as to avoid potential conflicts-of-interest, yet in effect has cut off funding for market research through investment banking revenue. The result has been a dramatic decrease in the number of research analysts, the elimination in coverage of smaller public companies, curtailed liquidity assessments of high-growth businesses, and a consequent reduction in public market transparency. NACIE believes such outcomes diminish investor confidence in public markets, particularly for smaller and younger firms, and contribute to the overall decreased incentive structure

for IPOs— limiting the options of later-stage high-growth firms seeking capital to finance their expansion and scale. We accordingly recommend revisions to the Spitzer Decree, so as to ensure sufficient and necessary information about later-stage high-growth companies enters the public domain.

#### **Recommendation 7: Permission for Analyst Coverage through Banking Revenue**

The SEC is encouraged to intervene in the implementation of the Spitzer Decree to permit investment banking revenue to fund research analyst coverage with a prominent warning label of conflicts of interest. Additional requirements should be established that mandate investment banks underwriting an IPO to provide analyst reports on the IPO issuer for at least 5 years.

Support for research analysts is necessary to ensure public market transparency for high-growth companies. An increase in transparency would ensure appropriate risk profile assessments for potential investors and increase investor confidence in later-stage deals or even prospective IPOs. Such a small but significant change could accordingly bring about a large scale increase in the ability of later-stage high-growth firms to once again tap public markets for much needed growth capital.

Nevertheless, in acknowledgement that the Spitzer Decree was implemented to avoid perceived conflicts of interest, we recommend that banking revenue only be permitted to fund analyst reports with prominent warnings of potential conflict of interests. This would ensure no misrepresentation of analyst's interests, while freeing up funds necessary to stimulate analyst coverage of high-growth firms. Further, a requirement on bank sponsors of IPOs to provide analyst reports into the immediate future may provide an even stronger role for analyst research. Mandated market assessments can ensure better collaboration between investment bankers and issuers in the IPO process, and help incentivize high-growth technology-based assets in the public markets over decimalized or private equity.

*\*This recommendation will require administrative action and falls under the purview of the SEC\**

### **3.3 Regulatory Exclusions for Initial Public Offerings**

Our final recommendation for increasing later-stage access to capital by high-growth companies relates to the regulatory burden associated with the 2002 Sarbanes-Oxley (SOX) Act. As noted in Chapter 1.2, SOX mandates a series of external audits on internal financial controls of public companies, in turn imposing an unnecessary compliance burden on smaller public companies that

pose little overall market risk. In fact, smaller public firms with less than \$100 million in revenue have been seen to spend up to \$2 - 4 million of their gross receipts on mandated SOX controls, siphoning off operating capital that could be better used to finance growth [9].

These regulations have in effect created disincentives for high-growth companies to pursue IPOs as a source of growth capital, relegating them to wait until they've reached revenues of \$100 million or more to reasonably afford compliance with SOX controls. NACIE sees this as a major deterrent to accessing public markets through IPOs and therefore a serious barrier to firm expansion as firms increasingly seek to be acquired or settle for slower growth rates.<sup>4</sup> Moreover, lagging incentives and access to the public markets have forced firms and investors to increasingly turn to unregulated secondary markets as a means of achieving liquidity. Intervention in the existing SOX legislation will help enable later-stage high-growth companies to access public markets.

**Recommendation 8: Mitigation of Sarbanes-Oxley Compliance for Smaller Public Firms**

The SEC should explore amendments to Section 404 of the 2002 Sarbanes-Oxley Act to ease the frequency and compliance controls of mandated external audits on smaller public companies (<\$2 billion market cap).

Encouraging SEC intervention in easing external audit compliance can responsibly bolster high-growth companies' access to the public markets. Institutional investors have noted that reducing external audit frequency requirements for financial controls from every year to even every other year would be well received by shareholders, increasing the incentives for firms to approach the public markets without fear of overly cumbersome regulatory controls. Resultant outcomes would encourage an increase in the number of smaller IPOs, while reducing incentives for early M&As that limit job growth and firm expansion in high-growth companies. While we leave the explicit line-item changes to SOX-404 to the discretion of the SEC, as well as the recently announced working group on small-cap IPOs led by former NVCA Chair Kate Mitchell, we're confident an overall small business exclusion from SOX will reduce the undue regulatory burdens on smaller public firms and improve access to later-stage growth capital.

*\*This recommendation will require administrative action and falls under the purview of the SEC\**

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<sup>4</sup> It is acknowledged that the decline in IPOs may also be associated with the general economic recession, as the IPO downturn started 2+ years before the enactment of Sarbanes-Oxley. Nevertheless, SOX has not helped to ease the situation in the public markets either, and we believe it remains a significant factor in deterring IPO access.



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## Appendix B: Abbreviations

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CRA	Community Reinvestment Act
DOD	Department of Defense
DOE	Department of Energy
IPO	Initial Public Offering
IRC	Internal Revenue Code
ISO	Incentive Stock Option
IT	Information Technology
LP	Limited Partner
M&A	Merger & Acquisition
NACIE	National Advisory Council on Innovation and Entrepreneurship
NIH	National Institute of Health
NQ	Non-Qualified Stock Option
PPACA	Patient Protection and Affordable Care Act
QSB	Qualified Small Business
R&D	Research & Development
ROI	Return on Investment
SBA	Small Business Administration
SBIC	Small Business Investment Company
SBIR	Small Business Innovation Research
SEC	Securities and Exchange Commission
SOX	Sarbanes-Oxley
STTR	Small Business Technology Transfer
VC	Venture Capital





## Appendix C: Acknowledgements

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