Written Testimony to the Small Business Committee of the U.S. House of Representatives
by Falon Donohue, CEO, VentureOhio
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1. Introduction

Chairman Chabot, Ranking Member Velazquez, members of the Small Business Committee, thank you for the opportunity to provide testimony for this important hearing. My name is Falon Donohue and I am the CEO of VentureOhio, a non-profit organization dedicated to the growth and diversification of Ohio's startup community. I am honored to represent the incredible entrepreneurs, innovators and investors who make up our membership and who are creating high-paying jobs in communities throughout the Midwest.

The proposals to encourage entrepreneurship through regulatory reform are critical to not only VentureOhio members but also to investors and founders across the country. And more broadly, in this new tech-based economy, these conversations affect all facets of the U.S. economy.

While conditions are ripe for continued innovation and economic expansion, there are underlying concerns about the ability of entrepreneurs and investors to reach their potential as job creators and maximize their impacts on communities—especially in areas between the coasts. VentureOhio suggests addressing restrictive regulations in order to create an environment in which capital flows more equitably to promising businesses in need.

In supporting these long-term, high-risk ventures—proven time and again to be the engine of our economy—we can ensure generations to come are able to turn bold ideas into world-changing businesses.

2. Momentum in the Midwest

The Midwest is in the midst of a renaissance—no longer a languishing "rust belt" of abandoned manufacturing facilities. As smart robotics and industrial automation proliferate, the Midwest is just as reliant on innovation and R&D as Silicon Valley.

In Ohio, we have seen remarkable growth in our entrepreneurial ecosystem. Venture capital activity is at the highest point ever, our annual report showing that investments have increased 46% since 2014. In 2016 alone, investors pumped $470 million into 210 Ohio startups.

The Midwest is earning a reputation as a promising new frontier in venture capital investing. For the past four years, AOL co-founder Steve Case has been traveling alongside renowned author JD Vance to seek out innovation in overlooked communities. Their $150 million Rise of the Rest fund has supported promising companies in a number of Midwest communities. Another supporter of the region, Columbus-based Drive Capital, has raised a half-billion dollars to invest in promising businesses throughout the Midwest—the publication TechCrunch noting it is spurring "an investment revolution in areas of the country that are more synonymous with tractors than with technological innovation." The ripple effects of these investments in underserved communities are profound, as they support high-paying jobs and the families of those workers.

Venture capitalists build help to ecosystems and support the key drivers of economic development - innovation, talent and capital. Columbus-based NCT Ventures funded and helped to launch the Center for Entrepreneurship at The Ohio State University to inspire Midwestern entrepreneurs for generations to come. In Detroit, legendary entrepreneur Dan Gilbert and and his team at Detroit Venture Partners have sponsored numerous accelerator and entrepreneurial startup activities to stimulate innovation in the Motor City.

Our brightest minds are now electing to stay in Columbus, Indianapolis, Detroit and other growing cities across the Midwest—they no longer feel like they need to leave for a coast to work at a thriving tech company. Local policymakers are supportive of the progress. The state of Indiana, for example, is now mandating computer science classes for every grade from K-12 in public schools.

Despite all these positive signals, one serious shortfall remains. America's heartland lacks the critical access to capital enjoyed in Silicon Valley, New York and Boston. Three-quarters of venture capital is being invested in just three states. Our home state of Ohio received less than 1%. Talent is equally distributed but, if capital continues to be concentrated in the hands of a few based on geography, we risk letting this momentum fade away.

This is perhaps the most exciting time for entrepreneurship in the history of the Midwest. To cultivate this high-risk, fast-paced environment, we must address the shortcomings and the underlying policies that can turn them into strengths.

4. Regulatory and Tax Changes

The hardworking startup founders and the investors that support them are in need of regulatory relief to reach their true potential.

Most of the capital invested in startup companies goes toward research and development, job creation and salaries, and other expansion activities. VentureOhio and our partners at the National Venture Capital Association (NVCA) recognize that founders, their employees, venture capital firms and angel investors must find the risk/return ratio worthwhile in order for the entrepreneurial ecosystem to flourish. If capital regulations and investment policy are hurdles to participation, investment in entrepreneurship will suffer.

Venture capital's influence on the American economy can not be overstated. In 1979, regulatory changes allowed pension funds to invest in VC, creating the modern venture capital industry as we know it today. According to a recent Stanford University study, 43% of the public companies founded between 1974 and 2015 were venture-backed. These companies represent 38% of the employees and 57% of the market cap of the "new" public companies.

While lower tax rates can have a substantial impact on many small businesses, venture-backed companies with negative income do not benefit from these changes. The ecosystem is in need of thoughtful policy specific to the companies and investors operating in the space.

Specifically, VentureOhio agrees with the following recommendations from the National Venture Capital Association which we believe will encourage new company formation:

- **The Volcker Rule**
  Formed in response to the 2007 financial crisis, the Volcker Rule aims to prevent banks from taking unnecessary risks. Unfortunately, it was written too broadly and unnecessarily prevents banks from investing in venture capital funds, eliminating a critical source of capital for startups. Section 619 of the Dodd-Frank Act includes "prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds" without any mention of venture capital. Investors and entrepreneurs would like to see a narrower interpretation to allow banks to participate in this proven source of job-creation and economic output. This regulation is especially burdensome to communities outside of major metropolitan areas, dampening entrepreneurship and economic activity where it is needed most.

- **Registered Investment Advisor Rules/Developing and Empowering Our Aspiring Leaders (DEAL) Act**
  Congress required hedge and private equity funds to become registered investment advisors (RIAs), but exempted venture capital funds and directed the SEC to define a VC fund. Seven years later, the definition needs to be modernized as many VC funds must now plan around how to stay within the confines to avoid registration. The DEAL Act, sponsored by Rep. Trey Hollingsworth (R-IN), directs the SEC to modify the definition of a venture capital fund to make certain qualifying secondary investments. In the venture ecosystem,these shares generally come from founders, early stage employees or individual investors who are seeking liquidity. VCs have been left with a choice to either limit their participation in certain financing rounds or incur significant compliance costs by becoming a registered investment advisor (RIA). It woulld be beneficial to allow VCs to continue providing equity investment to more of their portfolio companies, encouraging patient capital investment and long-term company growth. We strongly support theJOBS and Investor Confidence Act which contains the DEAL Act and passed the House by a 406-4 margin. We hope this can make it into law.

- **Expanded Research and Development Tax Credit**
  Current law allows very early stage startups—less than five years old and with less than $5 million in annual sales—to use R&D credits to offset up to $250,000 in payroll tax obligations. We believe Congress should expand this credit to startups with less than $100 million in assets, and allow them to offset up to $1 million worth of payroll taxes with R&D credits. The creation of the payroll tax offset for startups as part of the PATH Act was a promising start to encouraging the growth of innovative American companies, but the restrictions leave many startups unable to access the benefits of their R&D tax credits at a time when they are pouring considerable resources into R&D to build the enterprise. Increasing these limits will increase the country's global competitiveness and ensure startup companies can access the benefits of the R&D credit when they need it most. This will have significant impact in overlooked communities.

- **Maintaining Carried Interest Capital Gains**
  While many different factors have converged over time to create America's leadership in innovation, significant credit is due to our long-standing tax policy that supports the spirit

of entrepreneurship. One such policy is the capital gains treatment of carried interest received by venture capitalists. Carried interest is the primary economic incentive for participation in venture capital. Venture capitalists create partnerships with institutional investors (e.g. pension funds, endowments, foundations) and individual accredited investors. This partnership marries the talent, expertise, and personal capital of the venture capitalist with the capital of the institutional or individual investor to make high-risk, long-term equity investments into innovative startups. These are generally partnerships that last 10 to 15 years. Carried interest is the VC's share of gains (if there are any) from the partnership in accordance with the partnership agreement. Capital gains treatment of carried interest is an important feature of the tax code that properly aligns the long-term interests of investors and entrepreneurs to build great companies together since the creation of the modern venture capital industry. Venture capital activity is consistent with the core concepts of a long-term capital gains tax rate. As such, partnership gains attributable to the general partners of a venture capital partnership should continue to be afforded capital gains treatment.
When a startup fails, the carried interest on a deal is zero. In fact, carried interest is only realized if one or more startups in a venture capital fund are so successful as to offset the operational expenses and inevitable failures in the fund. Carried interest tax policy is defined by a simple equation, which holds that no benefit is extended unless and until our country receives the benefit of greater economic activity through company and job creation. This policy has been critical to our country's economic success. In a state like Ohio, which saw more than $600 million in new funds raised last year, a tax increase on carried interest could be devastating for our recently burgeoning venture capital community.

5. Conclusion

Entrepreneurship is the bedrock of the American economy. It leads a perpetual cycle of innovation and wealth creation that sustains high-paying careers and supports communities from Silicon Valley to Ohio.

When startups succeed, they produce the most revolutionary innovations that impact our communities, the country and humankind. A few targeted initiatives can positively impact capital formation for startups in the U.S., making long-term risk investment as attractive as possible. VentureOhio speaks for the state's community of entrepreneurs and investors when we urge Congress to create a clear and rational framework to allow America's entrepreneurial ecosystem to thrive for generations to come.

Thank you again to Chairman Shabot, Ranking Member Velazquez, and members of the Small Business Committee for your time and attention to this important matter.