

AH CAPITAL MANAGEMENT, L.L.C.
2865 Sand Hill Road
Menlo Park, California 94025

**Testimony of Scott Kupor, CEO & Managing Partner, Andreessen Horowitz,
Securities and Exchange Commission, Investor Advisory Committee
June 22, 2017**

Mr. Chairman, Commissioners and members of the Investor Advisory Committee, thank you very much for the opportunity to speak today regarding capital formation and the dearth of initial public offerings.

By way of background, I am the CEO and Managing Partner for Andreessen Horowitz, a \$6.5 billion multi-stage venture capital firm focused on IT-related investments. I also serve as the Chairman of the Board of Directors for the National Venture Capital Association. Prior to joining Andreessen Horowitz, I held several executive positions in a publicly-traded software company and was also an investment banker.

There are three related trends concerning IPOs and capital formation to note:

- First, the raw number of IPOs has declined significantly: From 1980-2000, the US averaged roughly 300 IPOs per year; from 2001-2016, the average fell to 108 per year.
- Second, the characteristics of IPO candidates have changed:
 - “Small” IPOs – companies with less than \$50m in annual revenue at the time of IPO – have declined from more than 50% of all IPOs in the 1980-2000 time frame to about 25% of IPOs from 2001-2016; and
 - Companies are staying private much longer – the median time to IPO from founding hovered around 6.5 years from 1980-2000; companies are now staying private for 10.5 or more years from founding.
- Third, the cumulative effect of these changes is a hollowing out of the broader US capital markets: the number of publicly listed stocks in the US declined by 50% from 1996 to 2016, while other developed countries have experienced a 50% *increase* over the same time period, creating a large listings gap relative to GDP growth over the last twenty years.

I believe there are a number of implications from these trends:

- First is jobs. Publicly-traded companies drive employment growth – companies that go public increase employment by 45% relative to private companies. Jobs of course remain key to the goal of sustained and broad economic growth, particularly growth and greater income equality in areas of the country that are undergoing structural unemployment challenges resulting from a modernizing economy.
- Second, I believe that we are at-risk of creating a two-tiered capital markets structure in the US: one in which the majority of the appreciation accrues to those institutions and wealthy individuals who can invest in the *private* markets and a second for the vast

majority of individual Americans who comprise the retail investor base in the *public* markets.

- A simple example illustrates this wealth shifting effect from *public* market investors to *private* investors. Microsoft went public in 1986 at a \$350 million market cap; today, Microsoft's market cap exceeds \$500 billion. Thus a public holding of Microsoft from IPO has had the opportunity to enjoy a return of more than 1,400x on her original investment. Amazon is a similar story: an initial public market cap of approximately \$440 million in 1997 that has grown just shy of 1,100x in the public markets. Contrast that with the incredible success story of Facebook, which debuted in the public markets around a \$100 billion market cap. While the company has performed exceedingly well in the public markets, the returns to public market investors are about 4.5x. For public investors in Facebook to achieve returns comparable to those of Microsoft and Amazon shareholders, Facebook would need to reach a market cap of \$100 trillion, a number that well exceeds the total global market cap of all listed stocks.
- While un-accredited Americans do have some access to private markets via the investments that some public mutual funds have made in private companies, the amount of this exposure is very limited. The value of mutual fund investments in *private* tech companies was estimated at just north of \$7 billion in 2016, or about .05% of total US mutual fund assets.
- Third, the long-term success of the US capital markets as a hub for global financial activity is at risk if the number of publicly listed companies continues its 20-year downward trajectory.

Unfortunately, while the data are clear, how we arrived at our destination is much less so.

The following represents my views on the three key drivers:

- First, it does not pay to be a small cap company in today's capital markets. While the overall efficiency goals of the Order Handling Rules, Reg ATS, Decimalization and Reg NMS are laudable, the impact of this market efficiency has been felt disproportionately by smaller cap, and thus lower trading volume, stocks. As spreads have narrowed, the economics for market makers have all but disappeared, making it unprofitable to trade in small cap stocks. Sell-side research, which had been traditionally funded via the trading spreads, also went away. In addition, the Global Research Settlement and Reg FD have contributed to the changing role of the research analyst – both in terms of the economics of the business and the role of the analyst vis-à-vis the buy-side. The economic challenges for investment banks that once specialized in this area thus increased and contributed to the consolidation that has taken place.

As a result, the small cap trading market is anything but liquid:

- The average small cap company has only two research analysts, compared with 12 for large caps. Fully 29% of small caps have no analyst coverage (vs. 1% for larger caps) and
- Small cap average daily trading volumes as a percentage of total stock float are 40% less than that of large caps.

Not surprisingly, therefore, institutional investors comprise only 27% of small cap shareholders, compared with 81% for larger cap stocks.

Thus, companies who would otherwise be small caps are loath to go public until they are a mid-cap or large-cap company. They fear being stuck in an illiquid trading environment, making it very difficult to raise additional capital in the public markets or to use their stock currency for acquisitions, both often critical to growing their businesses.

- Second, even if you are a large cap company that enjoys a liquid trading environment, it is difficult to balance long-term growth goals with the increasingly short-term investor orientation in public markets. At some point, if the pressures of being a public company are too great (and there is ready availability of capital in the private markets), companies will simply prefer to stay private for as long as possible. While these companies will ultimately go public, the time to going public will elongate and thus the returns to public market investors will continue to be muted.

Not only has the average investor hold period for stocks fallen from 8 years in 1960 to 8 months in 2016, but activist funds that were largely non-existent until the mid-1990's now well exceed \$100 billion in AUM. Couple this with the 50% decline in the number of publicly-listed US stocks and the pressure that short-term pressures can exert on a company has grown manifold.

This, I believe, is precisely why we have seen a simultaneous increase in the popularity of dual-class (or in some cases tri-class) voting structures for those companies that do in fact go public. Short-termism is acutely difficult for technology companies given the product cycle nature of these businesses – that is, product cycles are increasingly short-lived and thus the need for continued R&D investment and/or acquisitions is more acute than ever. Both of these activities can be near-term dilutive to EPS and thus raise the ire of short-term or activist-oriented investors. I am not here to defend dual-class stock, but rather to note that its resurgence is I believe a direct result of market structure shifts that favor short-term over long-term investor behavior.

- Third, the costs of being a public company are material. I want to be very clear on this topic, as I believe it is nuanced. While it is no doubt true that Sarbanes Oxley significantly increased the costs of being a public company and that other regulatory costs have also been imposed over the years – for example, the costs associated with

more liberal proxy rules, say on pay rules, and conflict mineral disclosure rules – many of these reflect the SEC’s dual mandate of investor protection and facilitating capital formation. And I believe strongly in that mandate.

So, I am not advocating for the elevation of one goal over the other, but rather suggesting that a one-size fits all approach to regulatory costs, independent of a consideration of the company’s financial resources to comply with those costs and the implicit funding tradeoffs, is required. These are monies that arguably could be directed otherwise toward growing the company or investing in research and development and, at the margin, the decision to go public has to incorporate this tradeoff. This issue is most acute for the small cap IPO candidate pool that is more likely to defer going public until it can rationally amortize these costs over a much higher base of earnings.

In the interest of completeness, the academic research also points to other potential theories that account for the decline in both small cap IPOs and in IPOs more generally.

For example:

- Some have argued that economies of scale have increased over the years and thus small companies would rather sell out to larger companies than risk competing against them as public companies. If this were the leading cause, however, I would expect us to have seen a substantial slow-down in the rate of venture capital funding of new companies more generally; in fact, we’ve seen the opposite. At least in my business, we don’t see economies of scale impacting the decision to start new companies that seek to challenge the dominance of large incumbents.
- Others have suggested that a different economies of scale is at work – that of the mutual fund industry. Mutual funds have in fact grown in size, reaching \$16 trillion in AUM, a 70x growth from 1990, and the dollars have become more concentrated among the top funds. When mutual funds get big, they are motivated to focus on large cap, highly liquid stocks for two reasons: (1) they need to be able to trade in/out of stocks without fear of illiquidity trapping them and (2) they are restricted by law (if they want to be a “diversified” mutual fund) from holding no more than 10% of the float of a company. So, while I do believe these are real issues, I think they point back to liquidity as the culprit, and ultimately the solution, for how to address at least the small cap IPO problem.

Given all of this, what can we do in the way of reform?

I believe that a comprehensive approach to reform is required given the variety of factors at play. And, as noted above, I believe all reform considerations need to be aligned with the SEC’s dual mandate around investor protection.

I do want to commend this organization for the positive work around the JOBS Act. There is no doubt that testing the waters, confidential filings and the scaled regulatory requirements have improved the on-ramp to the public markets.

However, now is the time for us to consider the market structure issues that impact what the “public markets highway” looks like once these companies in fact exit the on-ramp.

In particular, I would suggest that the Committee consider the following:

- First, we need to explore all avenues toward increasing liquidity in the small cap market as a means to engendering broader institutional support in that end of the market. Among the things I think the Committee should consider are:
 - First, continued work on the tick-size pilot. If we can reduce the number of increments at which small cap stocks trade, we may be able to garner sufficient liquidity to reduce the ingress and egress tax on institutional investors.
 - Second, we should consider ways to increase the attractiveness of research and market making activities to support the institutional investor base. That may include a mechanism to economically subsidize these activities – whether in the form of direct financial rebates or funding via the underwriting process – but also requires a look at whether elements of the Global Research Settlement, Reg FD or other regulatory rules are creating dis-incentives for banks to fund these activities related to small cap companies.
 - Third, we should consider whether reducing the number of trading venues, at least temporarily for newly issued small cap stocks, would help engender less fragmentation and thus improved liquidity.
 - Fourth, again, potentially for a limited period of time relative to a new issue, we should consider increasing the concentration cap limits for diversified mutual funds. Allowing mutual funds to hold slightly larger positions in newly issued stocks would increase the economic incentives for them – material appreciation in a stock could have a meaningful impact on the overall fund performance.
 - Fifth, the Committee should review the short interest rules as they apply to the small cap market and consider whether modification to these rules – including enhanced volume limits or disclosure requirements – particularly around a new issue should be implemented.
- Second, I believe the Committee should consider new mechanisms to balance short-term investor pressures with the desire of many public company management teams to focus on long-term investments. Among the suggestions are:

- One, tenure-based voting. Under this structure, voting rights accrete with holding periods; all investors – not just the management team or pre-IPO investors – can increase their voting power commensurate with their holding periods. Investors who are short-term traders would have less governance influence than would those who choose to hold the stock for longer periods of time. In the interest of full disclosure, my firm is an equity investor in a newly-formed company that is currently exploring this, among other approaches to incent long-term behavior, with the Commission.
- Two, the Committee should consider whether enhanced disclosure requirements for institutional investors around material short positions for all stocks would improve transparency and potentially decrease short-term pressures.
- Third, I believe that the Committee should undertake a comprehensive review of the costs of all current regulatory requirements to determine their economic impact on issuers of different sizes and to implement a more rigorous cost-benefit framework that requires an understanding of the marginal trade-offs new issuers and existing public companies make between investments in the growth of the company vs monies required to meet regulatory requirements. Again, none of this is to suggest that the core tenet of protecting the safe functioning of the capital markets against bad actors should be diminished. Rather, we need a refined framework that recognizes that the same nominal cost of regulation applied to IBM is disproportionate when applied to a sub-\$1 billion market cap company.

Summary

In summary, I would offer the Committee the following observations:

- The data on the dual phenomenon of fewer IPOs overall and a shift in the mix of IPOs – from small to large – are real and compelling. Our competitiveness in the global financial markets and our ability as a country to engender job growth, economic growth and greater economic equality are at-risk as a result of this trend.
- The private markets are taking matters into their own hands in light of the various structural challenges in the capital markets: companies are staying private longer, tapping new sources of capital outside of the public markets, seeking liquidity via private transactions and, therefore, accruing to themselves all of the benefits of stock price appreciation.
- Thus, the time to act is now and comprehensive changes to the structure of the US capital markets are required to reverse this trend.

Scott Kapor, CEO & Managing Partner, Andreessen Horowitz
Testimony to SEC Investor Advisory Committee
June 22, 2017
Page 7

I thank you for your time. While I have tried to offer a number of suggestions, these are by no means exhaustive. I am happy to make myself available to the extent the Committee determines to continue its work in this area and look forward to your feedback.