

2012 Election Analysis

President Obama won reelection on November 6th, winning 332 electoral college votes to Mitt Romney's 206. The President won all of the key swing states – Colorado, Iowa, Ohio, New Hampshire, Virginia, Florida, and Wisconsin. For a sitting President who faced not only a sluggish economy, but also struggled to bring his approval ratings above 50%, this was a strong comeback. Obama lost only Indiana, Missouri, and North Carolina compared to his 2008 victory. He picked up no state that McCain won in 2008. Obama's ability to "get the vote out" with key demographics in swing states gave him the strong electoral count he received. Having said that, the popular vote was extremely close, demonstrating the continued ambivalence of many Americans to the President and his policies.

Despite his victory, the President and his party must be eyeing the coming year warily. In contrast to 2010, the 2012 election was clearly not a "wave" election, with the populace voting for a dramatic shift in the country's direction. One might argue that the election's outcome is an endorsement of the continuation of the President's agenda. Yet, one might also argue that the voters, while handing victory to the President, have left in place the congressional dynamics that thwarted much of the Administration's agenda for the last two years. Before last night's election, the Democrats controlled the Senate by a margin of 53-47 – too small a margin to effectively control a legislative body constitutionally built around the concept of protecting minority rights. Those numbers post-election remain a tight split, with Democrats and Democratic leaning Independents holding between 53-55 seats. The GOP's inability to pick up a significant number of Senate seats is probably the most surprising outcome of the 2012 election cycle. However, in the House of Representatives, the power remains firmly in the hands of the Republicans who held their net losses to single digits. This strong GOP win can be directly attributable to the 2010 elections where Republicans did extremely well on the state level giving them the ability to direct reapportionment based on the 2010 census.

This was billed by many in the media as an historic election, setting the course of the nation for the next generation, and defining the nature of the social contract governing Americans' relationship to the state. History may prove this conjecture to be correct. But to get there, something must give or the nation will face four more years of governmental dysfunction. The make-up of the incoming Members of the House of Representatives as well as the Senate will factor heavily into whether we see détente in dealing with the critical issues facing the nation or whether we see a continuation of the partisan warfare that has dominated the legislative arena over the last several years.

Before the parties can look to 2013, however, we have to get through the remainder of 2012 and the compendium of legislative activity left undone before the election. Below is our analysis of the outlook for the lame duck session of Congress that will begin on November 13th, our evaluation of changes to anticipate in the new Congress and in the Administration, and finally, our outlook for policy issues that we believe will be front and center in the New Year.

The Lame Duck Congress and the Sequester

The complexity and breadth of issues that lay before Congress and the Administration between November 13th and the end of the year include significant short-term tax questions. Those include:

- the expiration of the Bush era tax cuts, (these cuts were not only to individual tax rates but also lowered the capital gains and dividend rates to 15%)
- the expiration of emergency unemployment benefits,
- the end of the Payroll Tax Holiday, and
- the end of the Alternative Minimum Tax exemption.

Separately, the Congress must also decide if, and how, to tackle the automatic spending cuts mandated under the Budget Control Act, which will take place on January 2nd of 2013. The sequester requires \$1.2 trillion in federal budget savings over 9 years; if not altered in the lame duck, the defense budget would see \$55 billion reduction in 2013, while the non-defense portion of the budget would also see \$55 billion less.

How Congress will choose to deal with the dual albatrosses or whether the Congress will be able to do so have been the subject of intense debate for the last 6 months. The most common conjecture is the following: in the lame duck session Congress will make a "down payment" towards the revenue needed to forestall the fiscal cliff sequestration. That revenue will be combined with certain entitlement reforms necessary to ensure Republican support, and the revenue and reform measure will outline a tight timeline for large-scale tax reform to be completed by the appropriate committees in 2013. If that particular diorama plays out as projected, we would not expect to see movement on carried interest or on capital gains more generally since both of those issues would fall under the rubric of large-scale tax reform.

However, if the President can lay claim to any mandate from his reelection, the most clear-cut mandate would be on the revenue side of the fiscal equation, especially around "taxing the wealthy" so that they pay "their fair share." While taxing carried interest at ordinary income rates could be on the table in that debate, most believe it is hard to separate that issue when full-scale tax reform is looming around the corner. Instead, the President could offer other avenues to increasing revenue in the short term, such as a phase-out in deductions based on income levels, or a return to a higher estate tax.

A significant number of Senators (those not up for reelection last night) have, on a bipartisan basis, been working on legislation for the lame duck that would prevent the sequester cuts and mandate tax reform. What is unclear at this point is whether those discussions have the blessing of either Democratic Majority Leader Harry Reid or Republican Minority Leader Mitch McConnell. Further, if the last two years have demonstrated anything, it's that House Speaker John Boehner sits atop an incredibly fractious and unpredictable caucus. Despite retaining control of the House last night, the Speaker must win reelection from his caucus in the lame duck. Until he passes that gauntlet assessing his positioning in any negotiation with the Administration or the Senate will be difficult.

The 2013 House of Representatives

Democrats fell well short of winning the net pick-up of 25 seats necessary to take control of the House, leaving that chamber firmly in Republican hands. With 2 races still undecided, the Republicans will go into 2013 with a ratio close to 234 to 201.

The incoming House of Representatives (the 113th Congress) will be one of, if not the most, inexperienced congresses in history. Between 40-50% of House members will have between 0-6 years of experience in Congress. These members will have to face some of the biggest issues head on that the country has ever faced: the budget, tax reform, China, immigration, healthcare, etc. Because of the inexperience in the House, party discipline could be problematic and finding solutions to pressing problems could take longer than many are currently anticipating.

Some noteworthy outcomes in the House include a number of moderate Democrats who won in hotly contested races (Matheson in Utah, and Barrow in Georgia), the loss of "Hollywood's Congressman" Howard Berman to fellow Democrat Brad Sherman, and the loss of Pete Stark who was a major member of the House Ways and Means Committee.

The education process on Capitol Hill never ceases. NVCA will continue to educate new Members and their staffs about the importance of maintaining and supporting a vibrant entrepreneurial sector, as well as about the integral role that venture capital plays in that ecosystem.

The 2013 Senate

More fortunate than their House counterparts, Democrats in the Senate pulled the fat out of the fire with their success in the November elections. Going into this cycle, Democrats had to defend 23 of the 33 seats up for election, and early betting was leaning heavily towards Republicans gaining control. A combination of late retirements from moderate Republican Senators like Olympia Snowe (R-ME) and what can only be considered implosions by several candidates in tight races (Richard Mourdock in Indiana and Todd Akin in Missouri) left the door open for Democrats to regain momentum and with it control of the Senate for the next 2 years.

As has happened in the House, the Senate is slowly also becoming more, not less, polarized as moderates leave and are replaced with new Members who are more liberal or more conservative than the folks they replaced. After the 2010 election with overwhelming Republican gains in the House, we saw the Senate become the nexus of the Washington power struggle. However, the 53-47 split in the Senate over the last few years bestowed the "majority" title on the Democrats but conveyed very little of the benefits. The 60 vote threshold will continue to be the real demarcation line in 2013 making the ability to pass virtually any piece of major legislation a Herculean task. Moderates we knew would be leaving after the Lame Duck session include Senators Snowe, Lugar, Lieberman, Nelson, and Webb. Other moderates who lost last night include Sen. Scott Brown and candidates Tommy Thompson, Heather Wilson, Linda Lingle and Bob Kerry.

The Administration

The President's re-election doesn't necessarily mean his Administration can hit the ground running. The President has done a remarkable job in keeping the lion's share of his appointees in their positions for four years. But, come January you will see many who will want to leave the Administration opening up major slots at Treasury, DOE, the SEC, and many other departments and agencies with which our community has dealings. This turnover will take time. Speculation on incoming cabinet members and key officials includes:

Treasury:

Jack Lew, current White House Chief of Staff; Erskine Bowles, current head of the National committee on Fiscal Responsibility and former White House Chief of Staff Larry Fink, Chairman and CEO of BlackRock Chair of the Federal Reserve:

Larry Summers, former Treasury Secretary
Janet Yellen, current Federal Reserve Vice Chair

DOE:

Byron Dorgan, former Senator (ND)

Jennifer Granholm, former Governor of Michigan

Jim Rogers, Chairman of Rogers Holdings & Beeland Industries

Dan Reicher, Former Assistant Secretary of Energy (EERE)

HHS:

Deval Patrick, current Governor of Massachusetts

Key issues in 2013

Regardless of election outcomes some issues appear to have momentum going into 2013. Immigration, cybersecurity, and review/repeal of the medical device tax could be looked at early in the new Congress depending on how issues such as the "fiscal cliff", sequestration, and immediate tax matters (Bush tax cuts, AMT patch, payroll tax) are resolved in the lame duck.

Tax Policy

Like it or not, tax policy will dominate much of the Washington agenda in 2013. Ironically this is even more likely if some type of "mini Grand Bargain" is achieved in the 2012 lame duck because any deal is likely to require a complete overhaul of the US tax code on a very tight timetable. While the venture community might relish a return to our traditional policy focus – advocating for issues like immigration reform or federal funding of basic R&D that enhance and support a strong entrepreneurial environment – we also have to face reality. If Washington is focused first and foremost on tax policy, we will have to be part of that debate as the only voice for entrepreneurs and venture capitalists alike.

Both Ways & Means Chairman Dave Camp (R-MI) and Senate Finance Chairman Max Baucus (D-MT) have spent the last year laying the groundwork for a tax reform effort, painstakingly holding hearings on nearly every aspect of the code. Both committees are expected to gain several new Members. While the dust won't settle on those assignments for some time, the changes to the Senate Finance Committee are likely to be most significant in terms of potential impact on the committee's agenda and views. Two Democratic Senators that are seeking a Finance Committee slot that are well-steeped in the venture industry's concerns are Mark Warner (D-VA) and Bob Casey (D-PA); on the Republican side, Sen. Rob Portman (R-OH) is vying for a coveted spot.

Of particular interest to entrepreneurs, VCs, and angels will be debate around issues such as:

- whether a meaningful rate differential between ordinary income and capital gains remains or whether capital gains should be eliminated entirely (even for entrepreneurs);
- whether flow-through treatment of partnership income continues or whether all "business" income is taxed at a corporate rate; and
- whether all tax credits (also called tax expenditures) are eliminated in order to raise revenue to allow for a lower corporate tax rate. This would impact both energy tax credits as well as many credits used by life science portfolio companies.

NVCA will continue our efforts to educate all Members of Congress on the importance of the kind of long-term, patient capital that the venture community has used and on the positive economic benefits that have subsequently flowed to the broader US economy as a result of a vibrant start-up landscape.

Immigration

Enactment of comprehensive immigration legislation could finally see the light of day in the new Congress. President Obama took some criticism during the campaign for failing to act on his promise to pass comprehensive immigration reform during his first term. Now, as he considers his legacy, and with the mini-DREAM Act already in place, expect him to partner with like-minded Republicans like Sen. Marco Rubio (FL) to get a bill done. Immigration has traditionally been a politically charged issue, but the most promising timeframe for a second term President to get this done is early on.

High-skilled *legal* immigration has traditionally enjoyed bipartisan support as both parties recognize the valuable contribution that foreign-born talent makes to the nation. However, the highly charged issue of *illegal* immigration has historically bogged down progress on immigration legislation. We anticipate that both parties will want to address both the legal and illegal aspects of immigration legislation together, rather than as separate, stand-alone bills. NVCA will continue to advocate for a streamlined path for high-skilled entrepreneurs, either in a comprehensive immigration bill that tackles legal and illegal immigration issues, or through stand-alone legislation like the Start-Up Visa bills championed by Senator John Kerry (D-MA) and Reps. Zoe Lofgren (D-CA) and Jared Polis (D-CO).

NVCA's 2006 immigration report, *American Made*, which studied the impact of immigrant entrepreneurs on the U.S. economy and on job creation will be rewritten to more accurately reflect the current state of venture-backed companies with foreign-born founders.

Cybersecurity

As NVCA has previously reported, the lack of progress on cybersecurity has frustrated the Obama Administration which views the nation's critical infrastructure as a prime target for terrorist attack. Key cabinet officials have been involved in the drafting of an Executive Order that will serve as a stop-gap measure until Congress can pass cybersecurity legislation. That Executive Order will likely be issued in the coming weeks and will establish a series of initiatives focused on the most vulnerable critical infrastructures; it will also contain some information sharing mechanisms. Even with the Executive Order, the President has indicated that Congress will need to pass comprehensive cybersecurity legislation in order to adequately protect the nation's utilities, businesses, government and other key interests. Since controversial privacy concerns remain, enacting a cybersecurity bill will take some time in the new Congress. The retirement of Senator Joe Lieberman (I-CT), who was the Senate's leading expert on this issue will further complicate this matter. Senator Tom Carper (D-DE), the likely chair of the Homeland Security & Governmental Affairs Committee, and Senator Jay Rockefeller (D-WV), the Chair of the Commerce Committee, will take on leadership roles on the issue in the next Congress.

SOPA/PIPA

Going into 2013, President Obama will continue to have the Federal Trade Commission (FTC) and Commerce Department focus on online privacy issues. Expect the FTC to continue to be aggressive on privacy enforcement, especially in the tech space, with more agreements with companies coming from the agency. The Commerce Department's mobile privacy initiative should be wrapping up by the end of the year and a series of recommendations are expected by late this year, early next. Even with these efforts, however, the President has tended to take a lenient approach to online privacy issues, promoting voluntary standards and industry involvement. That will not likely change, though changes at Commerce and FTC could result in more vocal advocates having a say on the policy front.

Full-Steam Ahead with ACA Implementation

President Obama's top health care policy priority for his second term will be to fully implement the Affordable Care Act (ACA). However, the mounting pressures to reduce federal spending will complicate matters.

In 2013, one of Congress' key priorities will focus on the growth in healthcare spending in the context of tax reform and reducing the federal debt. As part of this effort, there will be pressure to scale back some of the key provisions in the ACA including the expansion of Medicaid coverage and exchange subsidies. This will open the door for the President to work with Congress to make appropriate changes and tweak provisions of the law that have raised concerns now that election year politics are over.

Republicans will continue efforts to repeal and/or defund unpopular provisions of the ACA but will likely give up on efforts to fully repeal the law. They will also continue to highlight unpopular and highly expensive policies, and point to the fact that many Democrats also oppose them. This effort will help lay the groundwork to include these policies in a bipartisan "grand bargain" that will address the debt, tax and entitlement issues. It is also important to remember that Republicans have supported some of the policies in the ACA in the past including promoting value-based purchasing, innovative, efficient delivery models, and applying quality-based payments. NVCA is hopeful that these types of issues could provide an opportunity for Republicans and Democrats to work together on these critical issues.

Two of NVCA's top priorities already have bipartisan support and have traction to get repealed - the Independent Payment Advisory Board (IPAB) and the medical device tax.

IPAB: The IPAB is one of the most contentious provisions of the ACA. The board will consist of a 15-member panel that, starting in 2014, would recommend quality improvements to Medicare and cuts if spending grows too quickly—cuts that Congress can either accept or replace with similar reductions elsewhere in the program. Prescription drugs and biologics are likely to be first on the chopping block, since other areas of spending cuts are off-limits. President Obama wants IPAB to go even further by adding more enforcement and allow the IPAB to sequester funds as a "backstop" should Congress overrule its decisions. NVCA has strongly opposed the IPAB and believes it would be extremely harmful to the advancement of medical innovation.

Medical Device Tax - The medical device tax has continued to come under bipartisan criticism from Congressional members. The 2.3 percent tax on the sale of any taxable medical device, regardless of whether the underlying company is profitable, is set to take effect in January 2013. The House passed legislation to repeal the tax this Congress but the Senate Democratic leadership has been reluctant to debate any provisions to the ACA. With the election over, the Senate Democratic leadership might be willing to debate the issue in the context of overall tax reform. While there's a possibility that this could be addressed during the lame duck session, no one has yet tackled the other part of the debate: how to find a \$30 million "pay for" for repeal. If the industry is unsuccessful in getting an outright repeal, there could be an appetite to provide at least small company relief as a last case scenario.

Other aspects of the ACA that will come into play beginning in January, include: a \$2500 cap on health care flexible spending accounts; an increase from 7.5 percent of adjusted gross income (AGI) to 10 percent of AGI of the threshold for

itemized deductions for unreimbursed medical expenses; an increase in the Medicare Part A tax rate on wages from 1.45 percent to 2.35 percent of earnings in excess of \$200,000 (for individuals) or \$250,000 for married couples filing jointly; and the 2.3 percent excise tax on medical devices.

Obamacare II?

Since the ACA generally focused on reforming the insurance industry, many Democrats and Republicans believe there is a serious need to control health care spending by fundamentally changing how Americans pay for products and services. Recently a group of former Obama health care policy officials released an outline that the President could use as a blueprint for a comprehensive plan to stem the rise in spending. At the heart of the plan, the traditional fee-for-service model would be replaced by the privately negotiated bundled payments that would cover a patient's entire course of treatment. Those bundled payments would have to adhere to a "global spending target" for each state that would grow no faster than the average increase in wages. This type of approach could gain some bipartisan support in the new Congress.

FDA Reform Implementation

FDA's Commissioner, Margaret Hamburg, will likely stay for President Obama's second term as will most of the leadership in the Commissioner's office and at the Center for Drug, Evaluation and Research. There is talk, however, that the leadership at the Center for Device and Radiological Health might change in the New Year. Overall, NVCA believes it is important that the FDA leadership stays intact given the years we have invested in developing good working relationships with senior officials, helping them understand both the unique role venture capital plays in advancing medical innovation and the critical issues currently facing the medical innovation ecosystem.

One very positive development is Commissioner Hamburg's priority for 2013 to develop and lead a national strategy for biomedical and medical innovation. Several NVCA board members will be involved with helping this effort which will create another avenue to help move key medical innovation policies forward.

We are also hopeful that these ongoing relationships will help with the implementation of the FDA Safety and Innovation Act to ensure the new law will provide a more predictable and efficient regulatory environment for innovative products.

Sequestration's impact on the FDA

If sequestration goes through, it could very well impact FDA's ability to achieve its performance goal obligations included in the FDA Safety and Innovation Act (FDASIA). The FDASIA was signed into law this summer, reauthorizing the user fee programs for drugs and medical device reviews. The level of FDA budget

authority subject to sequestration is \$3.8 billion which reflects almost the entire budget of FDA. Unfortunately, sequestration could take the FDA's funding levels below FY 2010 levels and also cut into the user fees paid by manufactures. Stakeholders, including NVCA, will work hard to make the case to exempt the user fees from sequestration so FDA will be able to implement FDASIA and meet their performance obligations.

President's Advisory Council Report -- National Strategy for Biomedical Innovation To Accelerate Drug Development

NVCA is hopeful that President Obama will make the recent President's Council of Advisors on Science and Technology (PCAST) report a top priority in his second term. Entitled "Report to the President on Propelling Innovation in Drug Discovery, Development, and Evaluation", the report calls for a national strategy for biomedical innovation to accelerate drug development. Importantly, it incorporates many of the key messages and recommendations NVCA/MedIC has been advocating to address the current challenges facing the biopharma ecosystem.

Energy Outlook

The campaigns of both President Obama and Governor Romney focused heavily on energy issues, but notably, until Hurricane Sandy hit the East Coast, little attention was given by either to environmental issues or climate change. Both candidates touted their plans for energy independence and job creation; in the case of Governor Romney through more domestic drilling and in the case of President Obama through more renewable energy manufacturing jobs. The issue of the President's alleged "war on coal" was played out in down-ballot races in rural areas like Kentucky and West Virginia, and even parts of Ohio, but the lack of federal energy legislation meant that in battleground states energy issues were fought in more unconventional ways like bashing EPA regulations.

Now that the election outcome is known, a clearer picture can be gleaned for which energy and environmental policies will be addressed next year and it is clear that priorities such as, energy tax matters, manufacturing, rules addressing air pollution, and energy exports will be at the top of the agenda. Newly elected Senators like Tim Kaine (D-VA), Joe Donnelly (D-IN), and Martin Heinrich (D-NM) will likely be solid additions to the pro-renewable efforts in the Senate.

New York City Mayor Bloomberg's last minute endorsement of President Obama and his connection of that endorsement to the issue of climate change could bring that issue back to the forefront. In one light, it may seem futile for President Obama to pursue climate legislation since the Republicans in the House will continue to oppose it. But, the financial burdens required to rebuild from the damage to New York and New Jersey and the subsequent funding demands that will have to be made for the Army Corps of Engineers may spark new life into

the climate change debate. At a minimum, we expect the sharp rhetoric to escalate.

In the absence of climate legislation, expect the President to continue to authorize EPA to enact rules that reduce carbon-dioxide emissions, focusing on stationary sources such as power plants and refineries. The Obama Administration will continue its push for advancement of renewable energy on all fronts: everything from tax incentives to regulatory policies, to export policies to using the Defense Department to make gains in renewable energy will be pursued. Expect a decision on the Keystone XL pipeline to be made without the political pressures of a looming election and without fear of alienating the environmental community.

DOE Secretary Steven Chu is most likely to step down in the second term of Obama's Administration. Current names being floated in DC as possible replacements include: Former Senator Byron Dorgan (ND), Former MI Governor Jennifer Granholm, Former Republican Senator Richard Lugar (IN), John Podesta, Jim Rogers, and Dan Reicher.

The Senate Energy and Natural Resources Committee has traditionally been a very cordial and bipartisan committee under the leadership of Chairman Jeff Bingaman (D-NM) and Ranking Member Lisa Murkowski (R-AK). Now that Senator Bingaman has retired and Ron Wyden (D-OR) will take over the gavel, we expect the same level of bipartisanship to prevail on the committee.

While President Obama continues to call for passage of a Clean Electricity Standard, a divided Congress makes that unlikely. Instead, look for Murkowski and Wyden to try and find common ground on issues such as "revenue sharing" which incentivizes states to produce energy, either traditional fossil fuels or renewable energy, on federal lands and water. On the House side, since Republicans still control that chamber, we expect continued oversight on energy programs, but perhaps not with the same vitriol that we have recently seen.

In the new Congress, NVCA will work with a bipartisan group of lawmakers to introduce our energy innovation tax initiative and push for movement of that measure in the various tax writing and energy committees of both chambers of Congress.

Venture PAC

VenturePAC has long been a fundamental part of NVCA's public policy efforts. As a trade association, NVCA has been in Washington for nearly 40 years and our PAC has existed for over twenty years. Both are well known and well respected. This year in particular, it was critical to get out early and strong to support our allies in Congress and those challengers that we believe will be good additions to

the Congress. The early support of our friends in Congress was made possible by the robust support that VenturePAC receives from our members.

VenturePAC contributions for the cycle were over \$1 million - a very impressive figure for a relatively small industry association. For this calendar year, VenturePAC gave over \$225,000 to Senate incumbents and challengers, and gave almost \$650,000 to House incumbents and challengers. The remaining dollars went to party committees. Key races we picked early include:

<u>Senate</u> :	<u>House:</u>
AZ – Flake (R)	UT - Matheson (D)
NE – Fischer (R)	PA – Fitzpatrick (R)
PA – Casey (D)	GA – Barrow (D)
UT – Hatch (R)	
WVa – Manchin (D)	

Members of the Senate and House who lost and were important allies of the venture community include:

<u>Senate:</u>	<u>House:</u>
MA – Brown (R)	CA – Bilbray (R)
	NH – Bass (R)
	NY – Hayworth (R)

Conclusion

Venture capitalists are by their nature optimists and thus we view these elections as a time to inform the newly elected, and to re-engage with those returning about the venture process and its important contribution to moving our economy forward. Key issues that all policymakers must be aware of: basic federal R&D is a linchpin to long term economic growth; meaningful tax reform which celebrates long term investment over short term gain spurs entrepreneurial growth; an immigration policy which welcomes and keeps foreign born students and entrepreneurs in the US creates US jobs in the long run; our capital markets system must understand that emerging growth companies are the future for US competitiveness. We hope that these positive messages will resonate with our newly elected policymakers.