

## Silicon Flatirons Entrepreneurship Conference Report

### Introduction

On March 21, 2013, the Silicon Flatirons Center's fifth annual Entrepreneurship Conference focused upon *The Future of Entrepreneurial Finance*. The Conference convened three panels of experts from business, government, and academia.

Brad Bernthal, Director of the Silicon Flatirons Entrepreneurship Initiative, and Phil Weiser, Dean of Colorado Law and Executive Director of the Silicon Flatirons Center, welcomed the audience. They highlighted the growing role of Silicon Flatirons and CU as a convener for the Front Range's entrepreneurial community. Moreover, they emphasized the campus' role in attracting and training entrepreneurial talent as well as in creating opportunities for law and other CU-Boulder students amid a fast changing market.

The Entrepreneurship Conference traced trends in the dynamics of outside investment into startups. Three insights bear special mention. *First*, the Conference examined whether, in association with early investments into startups, capital can be effectively unbundled from control. Several trends in startup investing – ranging from the activity of “super angels,” to expanded use of crowd funding, to wider reliance of Rule 506 exemptions – suggest that the traditionally tight coupling of capital and control in startup investments may be evolving in a way that increasingly unbundles capital and control. *Second*, in examining the JOBS Act, panelists underscored the importance of removing the general solicitation ban in Rule 506 exemptions. Participants observed that this development will make Rule 506 even more attractive to emerging companies and, overall, may be the most important element of the JOBS Act. And *third*, in looking to the future of entrepreneurial finance, innovation could occur at two levels. One, at a regulatory level, the *Bank Holding Act* merits examination to determine whether it is locking in 10 year terms for VC funds, even in sectors such as biotechnology where a longer fund term may be appropriate. Two, at a private contracting level, funds may be well served to consider changes that include raising the commitment of general partners from 1% to 3% of a fund, allowing more flexibility with respect to GP team changes during the term of a fund, and more transparent reporting that would allow LPs to invest in “sidecars” alongside the VC fund. Each of these is elaborated upon below.

### ***Panel One: When Should Capital Be Bundled with Outside Management and Oversight?***

#### Panelists:

Nicole Glaros, Managing Director, *TechStars*

Sharon Matusik, Associate Professor, *Leeds School of Business*

Jon Nordmark, Chief Executive Officer, *UsingMiles*

Brad Bernthal, Entrepreneurship Initiative Director, *Silicon Flatirons Center*

Bret Fund (Moderator), Assistant Professor, Management and Entrepreneurship, *Leeds School of Business*

Brad Bernthal framed the first panel's discussion by introducing the classic Berle-Means problem. The Berle-Means problem refers to challenges associated with the separation of

ownership and management in widely-held companies. In public companies with a diffuse base of shareholders, so goes the Berle-Means analysis, control of the company is effectively transferred to the company's managers and away from its actual owners (the shareholders).

Traditional early stage financing has closely coupled "ownership" (i.e., an investor's equity position in a startup) with "control" (i.e., an investor's ability to be closely involved in the company's activities, sharing expertise with a company, and possessing powerful levers concerning a company's key decisions). In this way, as scholars have noted, Berle-Means is turned on its head in the financed startup model. Put in another way, when startups trade some portion of ownership for outside capital, they often do so in a way that results in a bundling of ownership and control when a single investor (or unitary block of syndicated investors) has significant voting rights, protective provisions, or board seats. This bundling of control and ownership is most common in traditional Venture Capital (VC) investments, although it is neither unique to the VC model nor certain to occur in a VC transaction.

After introducing this concept, Bernthal outlined the problems of entrepreneurial finance that the VC model is designed to address: extreme uncertainty, information asymmetries, misaligned incentives, and high transaction costs. Bernthal then presented what he described as the most important question facing entrepreneurial finance: is there anything unique about entrepreneurial finance that makes unbundling control and ownership so problematic as to be impracticable?

Bernthal staked out three hypotheses related to this question:

1. For startups in need of smaller outside capital investments (i.e., "super angel" sized investments of about \$500k or less), it is difficult for investors to justify the cost of monitoring and control (through participation in on-going management and company oversight) This explains one driver for greater separation of ownership and control in startups. Super Angels are already exploiting this gap— viz., super angels invest a smaller sized fund, make more small investments, and play where it is uneconomical for VCs to do so.<sup>1</sup>

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<sup>1</sup> Expected outcomes, rather than amount invested, are the critical factor in whether an investor's costs of monitoring and control are justified. Size of expected outcomes, however, will typically be related to the amount of invested. In combination with larger VC fund sizes, the costs of a board seat and active GP involvement with a startup are difficult to justify unless the expected outcome is sufficient to "move the meter" for a VC fund. The following contrasting scenarios help underscore the point.

Scenario 1: VC Fund 1995, a \$150M fund with 4 GPs, makes a \$5M Series A investment in 1995 for a 50% stake in NewCo. Things go well. VC Fund 1995 makes a follow on Series B round of \$5M additional investment, which we'll assume is syndicated such that the VC's stake remains at 50% (for easy math, 1x liquidation preference, not participating). NewCo exits in 2000 for a nice return of \$100M. Return to VC Fund 1995 = \$50M (a handsome IRR over 5 years). The size of return vis-à-vis the size of fund materially moves the meter for VC Fund 1995.

Scenario 2: VC Fund 2010, a \$1B fund with 8 GPs, makes a \$250K Seed Round investment in 2010 for a 20% stake in NewCo. Things go well. VC Fund 2010 makes a follow on Series A round of \$800K additional investment, which we'll assume is syndicated such that the VC's stake remains at 20% (for easy math, 1x liq pref, not participating). NewCo exits in 2015 for a return of \$25M. Return to VC Fund 2010 = \$5M (over 5 years = handsome IRR). But the size of return vis-à-vis the size of fund does not materially move the meter for VC Fund 2010.

2. Capital moving efficiently from an investor to a startup in a different geographical area (through, for example, expanded 506(c) solicitation or crowd funding structures) will require increased mindfulness of non-monetary needs of startups. Important constraints on behavior, such as reputation, will operate differently where investment occurs across locations. Especially as investors invest in startups from locations distant from the physical proximity of the company, new structures are required to address a startup's need for outside expertise as well as to constrain opportunistic behavior by startups at an investor's expense.
3. Capital unbundled from monitoring/control, from the startup's perspective, may be "less expensive" for the startup in terms of absolute cost, however, it also is likely less valuable than bundled capital. This may help explain the so-called angel paradox: VC's get better terms than angels because they add not just money but expertise. Angels get "worse" terms but they only put in money, not oversight.

After presenting the hypotheses, Bernthal joined the panel and the discussion began, moderated by Bret Fund.

The panel worked through the question of unbundling capital and management from several perspectives. The theme that arose was: "it depends."<sup>2</sup> In the case of unbundling capital and management, it depends on the people on both sides of the transaction.

From the perspective of the investor, Doug Johnson noted that in startup investments it is difficult to unbundle capital and management. The ability, or willingness, of an investor to invest capital without management oversight depends on the expertise of the pre-investment management team. Johnson noted that good investors can provide "three T's": Time, Talent, and Treasure. Investors will commit treasure alone only when they are very confident in the entrepreneurial team. These teams tend to be high-quality serial entrepreneurs and often they can raise smaller amounts from more people.

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The two premises behind hypothesis number one are that (1) VC does not scale, and (2) paying a GP intermediary is expensive and only makes sense where absolute returns are sufficient to exceed the costs of the intermediary. An individual GP can competently handle close engagement with companies somewhere in the 10 board seats range (+/- 5), depending on the person + companies involved. So let's say that an individual GP tops out at about 12 companies that s/he can help at a time. In an age where the average GP can deploy \$50M in funds, then the costs of and expected returns make sense vis-à-vis the relative cost of the GP intermediary. But in a sector where the average GP can only deploy \$8-10M in funds (say, early stage software plays, where startups need less), then the expected returns no longer make sense vis-à-vis the relative cost of the GP intermediary.

One solution to this, of course, is that if the IRR looks great, just hire more GPs. But this problem here is that VC does not scale. Persistence of GP returns suggests that VCs are not very fungible. Great ones are great; poor and inexperienced GPs get hammered.

<sup>2</sup> "It depends" happens to be the correct answer to every question ever asked in a law school building.

Nicole Glaros noted that in some instances, investors are forced to unbundle because smart portfolio management demands a sizable portfolio of investments, often too many to dedicate significant time to management. This analysis echoes of Bernthal's first hypothesis. Jon Nordmark pointed out that in other instances, investors do not want control. They know that the business is not likely to go the way the entrepreneur or investor thinks it will go. The investor instead believes in the people and passion they have for the startup and, as a result, leave the founders discretion to act without significant interference.

Glaros further emphasized a distinction between expertise and control. She underscored that TechStars regularly offers a startup access to deep expertise without taking strong control measures. Glaros also highlighted that, to the extent control measures are held by TechStars as an investor, the discretion to directly mandate or forbid certain startup actions is rarely exercised by TechStars.

From the entrepreneur's standpoint, to continue on the three T's theme, most entrepreneurs need all three at some level. However, entrepreneurs that have talent (the experienced entrepreneurs noted above) or that have access to time and talent support that is separate from treasure, in the form of excellent mentors and advisors, can often thrive with unbundled capital. This can come in many forms, including what Sharon Matusik called "modular" expertise where an entrepreneur may seek specific help with one or two issues.

Doug Johnson felt the key for entrepreneurs is to "know thyself", meaning that entrepreneurs must be intellectually honest (to borrow a phrase from Nicole Glaros) about their needs. If they are, they can then choose wisely whether to pursue bundled or unbundled capital. They also need to know the investor. Glaros pointed out that if she's an entrepreneur, she wants bundled capital if the person or people bundled with the capital are excellent people.

Matusik also noted that with bundled capital, entrepreneurs have to be aware of what they're getting into. VC funds are narrow and can be out of sync. Making sure there is real alignment of expertise, incentives, and timing is key.

Similarly, the panel noted that the capital that can come from crowdfunding, like other forms of unbundled capital, may not be optimal if the entrepreneur needs advice and oversight that bundled capital could provide. If the entrepreneur has no experience or sense of what to do with the money they receive, they might find that they still need the advice of experts. Crowdfunded capital is not, however, entirely unbundled. It comes with a community of supporters and a set of data that can be valuable to the entrepreneur even beyond the capital itself. Crowdfunding, at its best, can generate not only cash, but useful data and an army of evangelist-marketers for the company. One potentially strong combination is capital, community, and data from crowdfunding, combined with the expertise and mentoring of an accelerator.

## **Panel 2: *Sizing Up the JOBS Act***

### Panelists:

Steven Bradford, Earl Dunlap Distinguished Professor of Law, *University of Nebraska – Lincoln*

Jonathan Beninson, Chief Executive Officer, *First Funder*

Erik Gerding, Associate Professor, *University of Colorado Law School*

Richard Levin, Counsel, *Baker & Hostetler*

Monisha Merchant, Senior Adviser for Business Affairs, *Office of Senator Michael Bennet*

Brad Bernthal (Moderator), Entrepreneurship Initiative Director, *Silicon Flatirons Center*

Steven Bradford framed the discussion by explaining the key provisions of the JOBS act and how they impact businesses, specifically with respect to the registration requirements in the Securities Act. Because compliance with the registration requirements in the Securities Act is quite expensive, small startups are often precluded from selling securities to the public in ways larger companies can. The JOBS Act's key provisions impact the ability of smaller companies to raise capital in a few ways, although the precise details are still being worked out as the SEC deals with the challenge of writing the specific rules. The five significant changes that Bradford laid out are:

**General Solicitation** - Prior to the JOBS Act, companies could not engage in general solicitation of securities, meaning they not only could not advertise, but they could not solicit anyone who the seller does not have a pre-existing relationship with, essentially forcing most companies to pay a broker. The JOBS Act allows general solicitation, provided the sales are limited to accredited investors. This means that while the potential purchasers remain limited, the channels for reaching them are less limited.

**Crowdfunding** - The JOBS Act also allows equity sales by way of crowdfunding. The total amount that can be raised and the total amount that each investor can invest are limited. Additionally, there are significant disclosure requirements.

**Regulation A Exemption** - The JOBS Act adjusts the Regulation A exemption up from \$5M to \$50M. While this may help certain companies, it is not particularly impactful for early-stage startups who were already within the \$5M amount prior to the change.

**Exchange Act Reporting Requirements** - The Exchange Act reporting change that required reports to the SEC and to shareholders once a company had crossed the dual thresholds of \$10M in assets and 500 record shareholders was shifted to 2,000 record shareholders or 500 unaccredited shareholders. This is helpful to growing companies to extend the time before expensive registration requirements kick in, but tends not to be especially impactful to early stage startups.

**Emerging Growth Companies** - Finally, the Emerging Growth Company (EGC), which is somewhat of a misnomer because it includes companies with revenues below \$1B, has reduced reporting requirements and can contact accredited investors in advance if selling securities and get a confidential SEC review.

Bernthal, moderating the second panel, kicked off the discussion by asking the panelists which provision would matter most.

The panelists mainly cited the change to the general solicitation rules as the most impactful, although they disagreed on the nuance. Gerding felt that the general solicitation rules change is both the most important, but also poses the most risk because of the loss of one-on-one knowledge between the investor and the company. Historically, Gerding explained, the restriction had been designed to ensure that potential investors had the ability and leverage to protect themselves by negotiating for the information about the company that they needed. A ban on general solicitation, at least in theory, ensured a minimal relationship between the company selling securities and the potential investors. Lifting the ban allows the two sides to transact as complete strangers, and may make it easier for companies to raise money with minimal disclosures.

Beninson felt that the JOBS Act did not go far enough with the loosened restrictions on general solicitation. He felt that businesses are limited in the amount they can leverage the power of general solicitation because, even after the JOBS Act, the information that can be included in a general solicitation remains heavily restricted.

Bradford saw the potential for general solicitation to be a new way for companies to get in front of VC investors. A diligent VC could look through general solicitation data to find the diamonds in the rough and then invest as normal. Levin saw the opportunity in a different area, with general solicitation providing a more effective way to meet the demand for higher-risk investments with the potential to provide returns that have not been available lately.

Equity crowdfunding, although probably the most talked-about part of the JOBS Act, was not viewed by most panelists as especially attractive as a pure financing mechanism, especially under the \$500,000 level. Other motivations for crowdfunding may nonetheless remain powerful. Beninson, who leads a donations/rewards style crowdfunding platform, noted that crowdfunding is not just about money, but about the network effects and positive marketing, partly echoing the opinion of Nicole Glaros from the first panel. With that in mind, if a company accounts for some of the cost of crowdfunding as part of their marketing budget, the expense can be more reasonable.

Equity crowdfunding raises a number of issues that require careful thought (although it is necessary to start with the caveat that the SEC has yet to publish the final rules that it was directed to create for the JOBS Act). In any event, companies looking at equity crowdfunding have to carefully consider the consequences of having large numbers of small shareholders. They also have to do their due diligence on the crowdfunding platform. If the crowdfunding platform is operating outside of the rules, including but not limited to rules regarding broker-dealers,<sup>3</sup> the consequences to the company selling shares on the crowdfunding platform can be significant.

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<sup>3</sup> Merchant noted that there had been a great deal of discussion on whether or not to require crowdfunding platforms to register as broker-dealers. In the end, because the process to do so is so time consuming, it was decided that there would be no broker-dealer requirement. Levin pointed out that crowdfunding platforms could partner with existing broker-dealers, but that doing so is a very complicated process. Further, the crowdfunding section of the JOBS Act did not include express preemption of state broker-dealer rules, adding another level (or 50 levels) of complexity.

### **Panel 3: Future Fund Structures for Entrepreneurial Finance**

#### Panelists:

Jason Mendelson, Managing Director, *Foundry Group*

Christopher Jacoby, Senior Vice President of Private Capital Group, *AMG National Trust Bank*

Doug Johnson, Vice President, Capital Access, *Rocky Mountain Innosphere*

Jeff Kraft, Director, Business Funding and Incentives, *The Colorado Office of Economic Development and International Trade*

Eric Zabinski, Partner, *O'Melveny & Myers, LLP*

Scott Peppet (Moderator), Professor of Law, *University of Colorado Law School*

Jason Mendelson framed the discussion by providing an overview of where entrepreneurial finance, specifically VC financing, has been over the past 30+ years and where it stands today. VC began as a cottage industry of entrepreneurs who had made some money off of past ventures and were interested in investing that money in other entrepreneurial ventures. By the 1980s, VC was well on its way to becoming a professional industry with bigger funds and bigger fees. It had developed a standardized “2 & 20” structure, meaning that VC funds received 2% of the fund’s total amount as a management fee (regardless of fund performance) and another 20% of the profit of the fund.<sup>4</sup> As VC funds began showing outsized returns in the boom period of the mid-1990s, fund size grew enormously to the point where single funds were reaching \$1 billion. VC fund size (and number) grew rapidly until the tech bubble burst in 2000, after which VC as an industry shrank 50%.

In addition to the tech bubble, changes in technology – especially declining IT processing, storage, and movement costs – have allowed startups to launch and succeed with much less money. The common phrase is that \$500,000 is the new \$5 million.<sup>5</sup> This is problematic for VC funds because VC does not scale. Large VC funds (“large” meaning in this context meaning a fund size of over about \$250M) could previously be deployed over a fairly manageable number of portfolio companies with a small team of general partners. However, with technology developments allowing these portfolio companies to do much more with much less, large funds face a difficult situation of either investing in a substantially larger number of companies or investing larger amounts than necessary into the companies. If a VC fund does increase the amount of companies it invests in, then the support and mentorship they typically provide to those companies will necessarily decrease. Moreover, because of the unique blend of experience, network, and judgment that a general partner needs to bring, simply hiring more people is not a realistic option to solve the scalability problem.<sup>6</sup>

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<sup>4</sup> As an example, if a VC fund raised \$100M to invest, the VC would receive \$2M of that as a management fee, regardless of fund outcome. If the investment the fund made returned \$200M in total (for a profit of \$100M), the VC would receive 20% of the \$100M profit: \$20M of compensation known as carried interest.

<sup>5</sup> This saying is most accurate for IT/tech startups. Biotech and cleantech startups still face different and higher levels of capital intensity.

<sup>6</sup> Similarly, large funds that invest in VC funds as limited partners face a scale challenge. Choosing a good VC to invest in is much like a VC choosing a good entrepreneur to invest in: personal relationships and skills matter and it is very difficult to scale.

The increase in fund size has not only exposed the scaling problems of VC, but it has created misaligned incentives between VCs and the limited partners who invest in the fund.<sup>7</sup> Large amounts of capital under management create significant management fees, significant enough that they can create a comfortable income for VC general partners, bringing into question the incentive for diligent fund management.<sup>8</sup>

These problems have been exacerbated by an increasingly fractured landscape in entrepreneurial finance. A startup looking for funding now has a variety of viable options outside of the traditional VC funds, ranging from angels and super angels of various sizes to government funds or crowdsourcing. In light of this shifting landscape of funding options, the panel addressed the question: what is the future of fund structures for entrepreneurial finance?

The future, it seems, may be a return to the past. VC funds are adapting, with smaller investment sizes, smaller fund sizes, and closer relationships with entrepreneurs. The more successful funds keep a focus on developing networks and recognizing talent in order to bring in good ideas and entrepreneurs.

While some VCs are going back to the future, there are some changes that the panelists thought would be effective that would require significant changes in laws or industry norms. One issue that tends to hamper the funding of biotech especially is the 10-year timetable for VC funds. This results from the Bank Holding Act that prevents banks from holding assets for more than 10 years and as a result sets an arbitrary limit on VC funds. Allowing VC firms to invest for a longer period is key to long-lead startups like biotech plays.

Another challenge with VC firms is the structural rigidity that influences incentives. Because it is very difficult to make changes at the general partner level, and because compensation is set at the beginning of the fund and difficult to alter, general partners find themselves in a situation where they have very few consequences for bad behavior and limited incentives for above-average results. Making compensation and employment status more easily alterable would help align incentives within the fund and between the fund and its limited partners and portfolio companies, but would require overcoming significant industry norms.

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<sup>7</sup> See Diane Mulcahy et al, *We Have Met the Enemy... and He is Us, Lessons from Twenty Years of the Kauffman Foundation's Investments in Venture Capital Funds and the Triumph of Hope Over Experience* 2012, available at [www.kauffman.org/uploadedFiles/vc-enemy-is-us-report.pdf](http://www.kauffman.org/uploadedFiles/vc-enemy-is-us-report.pdf).

<sup>8</sup> Under the 2 & 20 model, a \$1B fund would receive \$20M in management fees, regardless of the performance of the general partners.