

The Evolution and Regulation of Venture Capital Funds

Erik P.M. Vermeulen and Diogo Pereira Dias Nunes

Abstract

Fundraising is one of the biggest challenges for venture capitalists in the wake of the financial crisis, causing some to argue that the venture capital model is broken? Maybe it looks that way, but actually the answer is that fundraising works differently. Indeed, this Paper shows that a 'Darwinian' evolution has led to profound changes in the venture capital industry – particularly in the area of venture capital fundraising. Venture capitalists should take these new trends and developments into account when deciding on how to structure future venture capital funds. This conclusion is based on empirical data that shows trends and developments in entrepreneurial finance and investments up to the first half of 2012. A few developments spring to mind, such as institutional investors taking a more active approach towards fund managers, the revival of corporate venture capital, the focus on investments in later stage startup companies, the development of micro-venture capital funds and the emergence of 'joint' funds. This paper discusses four strategies that may be deployed by venture capitalists. The first strategy relates to the 'survival of the fittest' trend. It appears that the best performing venture capitalists are still able to attract sufficient interest from institutional investors. They may only have to slightly tweak the traditional venture capital fund agreement to offer more protection to the institutional investors. A second strategy, involving the introduction of 'innovative' contractual provisions, aims to target more active investors. By offering customized separate accounts arrangements and deal-by-deal investment opportunities, fund managers attempt to attract these investors. The third strategy is moved by the idea that strategic – often corporate – investors will be able to improve and accelerate the fundraising process. Finally, venture capitalists can take a real partnership-type approach by setting up a new fund in which investors are selected on the basis of particular abilities and affinities. This paper holds important lessons for venture capitalists and their advisors, but also for policymakers and regulators who are increasingly contemplating the introduction of 'venture capital regulations'.

Keywords: Alternative Investment Funds Managers Directive, corporate venture capital, Dodd-Frank Wall Street Reform and Consumer Protection Act, European Venture Capital Funds Regulation, fundraising, government venture capital, institutional investors, limited partnership agreement, venture capital

JEL Classifications: G20, G23, G24, K20, K22, L22, L26, L51

The Evolution and Regulation of Venture Capital Funds

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1. Introduction

Venture capital drives innovation, economic growth and job creation.³ It is therefore not surprising that ‘venture capital’ is an important theme in the legal and regulatory reforms that have gained momentum in the wake of the recent financial crisis. Clearly, the economic downturn had (and still has) a severe impact on the venture capital industry.⁴ What can be done to stimulate venture capital investments and make it better and more accessible to emerging growth companies? Policymakers and regulators are convinced that regulatory interventions should aim at creating a virtuous ‘venture capital cycle’ by (1) boosting venture capital fundraising (particularly from institutional investors), (2) promoting venture capital and other risk capital investments in promising, mostly early-stage growth companies, and (3) encouraging access to capital markets in order to improve liquidity and exit opportunities that enable venture capital funds to return capital to their investors.⁵

In this paper, we distinguish between two types of regulatory interventions that should ensure a smooth working of the ‘venture capital cycle’. Firstly, policymakers and regulators acknowledge that venture capital funds should be exempted from the new stringent registration and reporting requirements for alternative investment fund advisers/managers. These regulations seek to reduce systemic risk and promote the stability and efficiency of the financial markets. The Alternative Investment Funds Managers Directive (AIFMD) in Europe and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in the United States offer good examples of regulations that include ‘venture capital exemptions’. Secondly, we observe regulatory initiatives that are expected to boost the venture capital industry. The Regulation on European Venture Capital Funds

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3 See Paul A. Gompers and Josh Lerner, *The Money of Invention, How Venture Capital Creates New Wealth*, Harvard Business School Press, 2001.

4 See Joern Block and Philipp Sandner, *What is the effect of the current financial crisis on venture capital financing? Empirical evidence from US internet start-ups*, MPRA Paper No. 14727, April 2009; Ben Rooney, *European Venture Capital Poised for Rebound*, *The Wall Street Journal*, TECHEurope, 4 May 2012.

5 See Paul Gompers and Josh Lerner, *The Venture Capital Cycle*, The MIT Press, 1999.

is an example that we discuss in this paper. The rationale behind these initiatives is simple: stimulating a rapid and smooth process of raising, structuring and exiting funds is crucial to start and restart venture capital cycles, but also to develop a sustainable and robust venture capital industry.⁶ Section 2 discusses and analyzes the venture capital exemptions in the AIFMD and the Dodd-Frank Act. It then turns to the Regulation on European Venture Capital Funds. We mainly focus on the European reforms and compare them with the regulatory responses in the United States.

So, what can we expect from the ‘post-financial crisis’ legal and regulatory interventions?⁷ Surprisingly, we find that those expecting a quick turnaround in the venture capital industry should not hold their breath. We label the potential problem with the legal and regulatory reforms as optimism bias (or ‘unrealistic optimism’).⁸ Optimism bias, which refers to the belief that the future will irrefutably be brighter and more prosperous than the past or present,⁹ could result in an increase of indirect/hidden costs involved with regulatory intervention. When we refer to hidden costs, we talk about the money that policymakers throw into the design of rules and regulations that do not have the expected impact on the market. These costs also include the loss of time in discussing, drafting and producing better and more effective regulatory proposals. Clearly, in the event of legal and regulatory reforms being counterproductive – in terms of encouraging activities that go against the current non-regulatory trends and developments in the industry – the hidden costs will increase significantly.¹⁰

Why then is there a potential optimism bias problem with the proposed ‘venture capital exemptions’ and ‘venture capital regulations’? Section 3 shows that a ‘Darwinian’ evolution is currently occurring in the venture capital industry, leading to profound cultural changes – particularly in the area of venture capital fundraising.¹¹ This conclusion is based on empirical data that shows trends and developments in entrepreneurial finance and investments in the post-financial crisis era (up to the first half of 2012). A few developments spring to mind, such as institutional investors taking a more active approach towards fund managers, the revival of corporate venture capital, the focus on investments in later stage start-up companies and the emergence and development of micro-venture

6 See http://ec.europa.eu/enterprise/policies/finance/index_en.htm. Another example of a regulatory initiative that has recently been implemented with the aim to foster entrepreneurship is the American Jumpstart Our Business Startups Act of 5 April 2012 (H.R. 3606). See Joseph A. McCahery and Erik P.M. Vermeulen, Corporate Governance, IPOs and Economic Growth, Working Paper 2012.

7 See also Josh Lerner, *Boulevard of Broken Dreams, Why Public Efforts to Boost Entrepreneurship and Venture Capital Have Failed – and What to Do About It*, Princeton University Press, 2009. See also European Commission, ‘Impact Assessment accompanying the document Proposal for a Regulation of the European Parliament and of the Council on European Venture Capital Funds’, Commission Staff Working Paper, SEC(2011) 1515.

8 See, for example, Curtis J. Milhaupt, *Japan’s Experience with Deposit Insurance and Failing Banks: Implications for Financial Regulatory Design?*, Washington University Law Review, vol. 77, 1999.

9 See Tali Sharot, *The Optimism Bias, Why We’re Wired to Look on the Bright Side*, Constable & Robinson, 2012. See also Richard H. Thaler and Cass R. Sunstein, *Nudge, Improving Decisions About Health, Wealth, and Happiness*, Penguin Books, 2009.

10 See also European Economic and Social Committee, Opinion of the EESC on the Proposal for a Regulation of the European Parliament and of the Council on European Venture Capital Funds, 2012/C 191/13, 29 June 2012 (noting that there may be limited interest in the European passport if the Commission omits to address the main problems in the venture capital industry).

11 See Janke Dittmer and Erik P.M. Vermeulen, *The “New” Venture Capital Cycle: From Vicious to Virtuous*, Working Paper, Forthcoming 2012.

capital funds.¹² These developments appear to reduce the importance and the ‘recovery’ impact of the proposed regulatory initiatives on the workings of the ‘venture capital cycle’. A clear understanding of the evolution of the industry not only holds important lessons for policymakers and regulators, but also for investors, venture capitalists, entrepreneurs and their advisors. These lessons go beyond and even contradict traditional and current thinking about the role of venture capital funds in the financial market. For instance, it is currently a common refrain that the ‘venture capital cycle’ is broken.¹³ Section 3, however, shows that the model is not broken, but it is evolving and it needs venture capital fund managers to evolve with it. We conclude in Section 4.

2. The Regulation of Venture Capital Funds

In economics jargon, the venture capital market is replete with information asymmetries.¹⁴ There is inevitably a high degree of information asymmetry between the fund managers, who play a relatively active role in the development and growth of portfolio companies, and the passive investors, who are not able to closely monitor the prospects of each individual start-up. Legal practice, however, has developed contractual governance and incentive techniques that are widely considered to be effective in limiting opportunism and controlling the level of risk.¹⁵ For example, a fund’s duration is usually ten years with a five years investment period, making it possible for investors to estimate with reasonable accuracy until when the venture capital firm can make fresh investments and, most importantly, when they ultimately will be able to recover their investments, including profits. In order to align the interests, the fund managers are also required to make a capital commitment. Typically the managers will invest 1% of the fund’s total capital commitments. Another key contractual technique is the compensation arrangement between the fund managers and the investors. Compensation usually consists of two main sources. Firstly, fund managers are typically entitled to receive 20% of the profits generated by each of the funds, the carried interest. A second source of compensation for the fund managers is the annual management fee, usually 2% - 2.5% of a fund’s committed capital.

In this context (and to protect the investors against overcompensation for the management activities), the investors’ clawback provisions are worth mentioning. A clawback provision is typically triggered if carried interest is paid to the fund managers at an earlier stage of a fund’s life, which later – due to disappointing results in later stages – appears to be more than the managers were entitled to under the compensation arrangement. Arguably, clawback provisions are less relevant in Europe where investors have often bargained for the inclusion of other protections in the agreement. For

¹² See Amy King, Rise in secondaries highlights tough venture market, unquote, 15 June 2012.

¹³ See, for instance, Batten Institute, Collapse or Comeback? The Venture Capital Debate, A Research Briefing from the University of Virginia’s Darden School of Business, June 2011.

¹⁴ See BIS, Department for Business Innovation & Skills, SME Access to External Finance, BIS Economics Paper No. 16, January 2012.

¹⁵ See Joseph A. McCahery and Erik P.M. Vermeulen, Limited Partnership Reform in the United Kingdom: A Competitive Venture Capital Oriented Business Form, European Business Organization Law Review, Vol. 5, 2004. See also Section 3.2.

instance, investors tend to ensure fund managers' performance by insisting on hurdle rates (or preferred returns) that vary from 7% - 10%, which means that profits can only be distributed to fund managers after a certain profit threshold – a minimum annual internal rate of return – has been satisfied.¹⁶ Profit distribution arrangements that require venture capital firms to first provide a preferred return before being able to distribute the 'carry', significantly reduce the chance that managers receive more than their fair share of the profits. In order to keep the managers focused and incentivized, the venture capital fund agreements usually contain 'catch-up' provisions. If fund managers are able to meet the hurdle rate requirement, they will be rewarded by the catch-up provision that entitles them to receive most of the profits until the contractually agreed profit-split between the investors and the managers has been reached.

Investors thus largely rely on the contractual flexibility of the fund's legal form (usually a limited partnership or other flexible business form) in aligning the interests of fund managers and protecting their investments.¹⁷ Despite the high reliance on contractual mechanisms in a venture capital fund's dealings with investors and its portfolio companies, national 'private placement' rules and regulations often 'supplement' the contractual protection of investors. Here, private placement is understood as the marketing and sale of 'investment interests' in venture capital funds to a limited number of professional investors, such as institutional investors, corporations and wealthy individuals. The downside of the application of these rules is that attracting investors significantly increases the compliance costs and fundraising complications. This is particularly prevalent in Europe where the regulatory systems of the member states are still fragmented and only harmonized to a certain extent. For instance, several European member states apply prospectus rules and requirements to venture capital offerings. Examples are Austria, Belgium, France, Germany, the Netherlands, Sweden and the United Kingdom. Other member states require local registrations. Even in areas where European Directives have had a harmonizing effect, differences in interpretation make the establishment of a truly European venture capital fund often feel like running the gauntlet. Consider here the offering of German limited partnership interests in France. The offering is not considered as an investment service in Germany, but requires an additional authorization in France if the interests are marketed in France (where these offerings are viewed as an investment service).¹⁸

Given the regulatory differences between the member states, it should come as no surprise that European policymakers and regulators are currently contemplating a regulation that enables venture capitalists to obtain a European passport. A possible solution to the regulatory barriers of setting up a European-wide fund is to allow venture capital fund managers to ask for a European registration in the home member state, which would then automatically be mutually recognized in other member states.

16 See Dow Jones & Company, 'Dow Jones Private Equity Partnership Terms and Conditions', 2009 edition (2009).

17 See Joseph McCahery and Erik P.M. Vermeulen, *Corporate Governance of Non-Listed Companies*, Oxford University Press, 2008.

18 See European Commission, 'Impact Assessment accompanying the document Proposal for a Regulation of the European Parliament and of the Council on European Venture Capital Funds', Commission Staff Working Paper, SEC (2011) 1515.

The application of a single rulebook that would govern the marketing and sale of ‘investment interests’ in venture capital funds should make it easier for and provide incentives to investors to participate in foreign funds. This passport system would help defragment the venture capital market, allegedly resulting in more, bigger and cross-border oriented venture capital funds. The idea is simple. If ‘European Venture Capital Funds’ were big enough to meet a start-up’s capital needs in all (both early and later) stages of its development, more promising start-up companies would be able to receive financing, which would in turn encourage job creation and economic growth. Moreover, a passport regime would arguably lead to an increase in the number of venture capital funds, making it easier for these funds to engage in risk-sharing through the well-developed practice of syndicating with other risk capital investors.¹⁹ Clearly, the risk-sharing opportunities are particularly important to emerging growth companies that are in their earlier – and riskier – growth stages. There will be two options to obtain this passport. The first option is through the application of the AIFMD. The second option is through a proposed regulation that would make it possible for venture capital funds to be designated as a European venture capital fund. We will first turn to the AIFMD and explain why there is a need for an alternative regulation on venture capital funds in Europe.

2.1 The AIFMD

The AIFMD provides a marketing passport for managers of Alternative Investment Funds (AIFs) that fall outside the scope of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive, such as hedge funds, private equity funds and real estate funds.²⁰ The rationale behind the AIFMD is to develop a uniform set of rules and regulations for AIFs that protects investors and other market participants. AIF managers that comply with the rules of the Directive and have obtained the ‘passport’ will be allowed to manage or market funds to professional investors throughout the European Union.²¹ Since AIF managers’ decisions affect investors in different member states, the AIFMD aims to introduce a comprehensive and secure regulatory framework that ensures proper monitoring and prudential oversight of alternative investments that pose systemic risk. Strict rules on transparency and disclosure, valuation, risk and liquidity management, the use of leverage, remuneration, conflicts of interest, and the acquisition of companies are expected to enhance public accountability and the protection of investors (see also Table 1). In order to further reduce the problems arising from information asymmetries, the AIFMD requires the AIF’s assets to be safe-kept by an independent depositary, which is subject to high liability standards.²²

¹⁹ See Paul Gompers, Vladimir Mukharlyamov and Yuhai Xuan, *The Cost of Friendship*, NBER Working Paper Series, Working Paper 18141, June 2012. See also Section 3.1.

²⁰ See Articles 2 and 4(1)(a) and (b) of the AIFMD.

²¹ See Articles 31 to 33 of the AIFMD.

²² See Article 21 of the AIFMD.

Venture capital funds are also viewed as AIFs.²³ This is remarkable, because it is widely acknowledged that this asset class does not impose systemic risk to the financial market.²⁴ On the contrary, venture capital is usually viewed as the key ingredient to job creation and economic growth.²⁵ Strict application of the stringent (and costly) AIFMD rules would arguably have a decreasing effect on the supply of venture capital, thereby seriously hampering the working of the venture capital cycle. Not surprisingly, therefore, the AIFMD contains certain exemptions that are applicable to venture capital funds.²⁶ Article 3(2) states that, besides certain registration and notification duties, the AIFMD does not apply to (a) AIF managers which either directly or indirectly (through a company with which the AIF manager is linked by common management or control, or by a substantive direct or indirect holding) manage portfolios of AIFs whose assets under management, including any assets acquired through use of leverage, in total do not exceed a threshold of €100 million; or (b) AIF managers which either directly or indirectly (through a company with which the AIFM is linked by common management or control, or by a substantive direct or indirect holding) manage portfolios of AIFs whose assets under management in total do not exceed a threshold of €500 million provided that the AIFs are unleveraged and do not provide for redemption rights exercisable during a period of 5 years following the date of initial investment in these AIFs. Most venture capital fund managers (97%) will most likely be exempted from the AIFMD, because (1) they have less than €500 million in assets under management, (2) they generally do not employ leverage (which could arise from borrowing of cash or securities or from positions held in derivatives) or (3) redemption rights.²⁷

The AIFMD provisions slightly deviate from the registration measures introduced by the Dodd-Frank Act in the United States. The US counterpart of the AIFMD significantly extended the registration requirements under the Investment Advisers Act of 1940 to include advisers of private funds, such as hedge funds and private equity funds. The rationale behind the Dodd-Frank Act is, similarly to the AIFMD,²⁸ to reduce financial market failures or systemic risk.²⁹ Venture capital funds are exempted,³⁰ because, as discussed, they do not threaten the stability and continuity of the financial system. Generally, there are two reasons for this: (1) the funds and their portfolio companies use little or no debt and (2) the venture capital industry is relatively small (venture capital funds in the United States invest approximately \$ 30 billion each year, which amount is too small to pose systemic risk).³¹

23 As can be concluded by analyzing the definition of ‘AIF’ contained in Article 4(1)(a) of the AIFMD.

24 See European Commission, A new European regime for Venture Capital, Public Consultation Document, 15 June 2011.

25 See Dan Primack, Leveraging venture capital, CNNMoney, 11 July 2012.

26 See Articles 3(2), 16(1), 21(3) second subparagraph, and 26(2)(a) of the AIFMD.

27 See Charles River Associates, Impact of the proposed AIFM Directive across Europe, CRA, 2009.

28 See Global regulatory trends in the hedge fund industry raise barriers to entry, Finance Dublin, February 2010.

29 See Viral Acharya and Matthew Richardson, The Dodd-Frank Act, system risk and capital requirements, VOX – Research-based policy analysis and commentary from leading economists, 25 October 2010.

30 See SEC Adopts Dodd-Frank Act Amendments to Investment Advisers Act (<http://www.sec.gov/news/press/2011/2011-133.htm>)

31 See James Freeman, Is Silicon Valley a Systemic Risk? Treasury decides to treat venture capitalists like hedge funds, The Wall Street Journal, 9 April 2009.

Now if we compare the exemption in the Dodd-Frank Act with the one in the AIFMD, we observe a major difference. Instead of introducing an asset under management threshold,³² the Dodd-Frank Act ‘simply’ exempts advisers that only manage one or more venture capital funds.³³ The Securities and Exchange Commission (SEC) defines a venture capital fund as a private fund that directly acquires equity securities, including stock, warrants, convertible debt and bridge funding, in privately held companies.³⁴ These equity securities are viewed as ‘qualifying investments’. In addition to making these qualifying investments, 20% of a fund’s committed capital might be invested in non-qualifying investments. For instance, stock purchases from existing shareholders in the secondary market are non-qualifying investments under the venture capital exemption. In light of the traditional venture capital cycle in which funds primarily invest in start-up companies, fund managers generally do not have to comply with the cumbersome and time-consuming registration provisions of the Investment Advisers Act, provided that they do not borrow or otherwise incur leverage on a long-term basis and do not offer redemption rights to its investors.³⁵

The US National Venture Capital Association generally heralded the venture capital exemption under the Dodd-Frank Act (as clarified by the SEC definition of venture capital fund). This is understandable: The definition closely reflects what venture capital funds do in the different stages of the traditional venture capital cycle.³⁶ The definition is consistent, clear and, most importantly, broad enough to exempt most of the venture capital funds that are active in the industry without running the risk that the exemption will be misused by other types of funds.³⁷ In this respect, the result is essentially the same as that under the AIFMD. Yet, the different approach of article 3(2) of the AIFMD leads to a conundrum for venture capital funds and their managers in Europe. Indeed, they have to take at least two consequences into account that may even be inconsistent and mutually exclusive (see also Figure 1). Firstly, the application of the AIFMD leads to higher compliance costs, giving venture capitalists in Europe an incentive to stay below the threshold of €500 million in assets. Secondly, the AIFMD offers a means to avoid compliance with the patchwork of national rules and regulations when offering venture capital fund investments throughout the European Union. In order

32 Please note that the Dodd-Frank Act applies an asset under management threshold of \$150M to private fund advisers. See Sec. 408 of Title IV of the Dodd-Frank Act.

33 See Sec. 407 of the Dodd-Frank Act.

34 See Sec. 275.203(l)–1 of Part 275, Chapter II, Title 17 of the Code of Federal Regulations (CFR). See also Read SEC’s Final Rules on Venture Capital Exemption, *The Wall Street Journal Venture Capital Dispatch*, 23 June 2011.

35 Note that these two conditions correspond to the ones set in the AIFMD. See Sec. 275.203(l)–1(a)(3) and (4) of Part 275, Chapter II, Title 17 of the CFR.

36 See NVCA, Letter Re: Public Comments to Notice of Proposed Rulemaking regarding Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (the Proposed Rule), 3 February 2012.

37 Some argue that the SEC’s definition is not broad enough. They note that “in the age of larger, capital-hungry social media and gaming companies such as Facebook Inc., Groupon Inc. and Twitter Inc., and the advent of private markets such as Second Market, the opportunity for venture capitalists to purchase stock from existing shareholders has increased dramatically.” They continue by arguing that “the SEC does not deem that type of activity venture capital investing.” See Gordon R. Caplan, Barry P. Barbash and Stephen O’Conner, *So you think you’re a venture capitalist?*, *The Deal Pipeline*, 23 August 2012. Others believe that, despite the rather limited definition of a venture capital fund, legal practice will find a solution for most secondary “venture capitalists”. They predict that secondary transactions will be structured as primary share issuances coupled with a repurchase of shares. See Al Browne and Eric Grossman, *Growth Equity: A Lawyer’s Perspective*, *Venture Capital Review*, 2011.

to streamline the fundraising process, venture capital fund managers may thus have an incentive to obtain an EU-wide passport by either choosing to have more than €500 million under management or by formally opting-in to the AIFMD regime. In both cases they have to comply with a stringent and onerous set of rules and obligations. A cost-benefit analysis regarding the cumbersome application of the AIFMD rules leads to the conclusion that the AIFMD's exemption option will most likely prevail in the venture capital industry.

Certainly, there are some regulatory exemptions if the AIFMD applies to venture capital fund managers. For instance, investments in small and medium-sized enterprises (SMEs)³⁸ – these usually include the portfolio companies of venture capital funds – are exempted from the mandatory notification and disclosure requirements that normally surround the acquisitions of major holdings and control in non-listed companies,³⁹ as well as from the AIFMD's safeguards against asset stripping.⁴⁰ Besides the exemptions, the AIFMD further provides for a lighter regulatory regime for venture capital fund managers: (1) venture capital funds will often be allowed to appoint a notary, a lawyer, a registrar or another entity to carry out depositary functions (since these funds usually have no redemption rights exercisable during the period of 5 years from the date of the initial investments and mainly invest in non-listed SMEs),⁴¹ and (2) venture capital funds will generally not be required to comply with the strict liquidity management requirements (since these funds are usually considered as unleveraged closed-end funds).⁴² Finally, the fact that the AIFMD should be applied proportionally (in order not to go beyond what is necessary to achieve its objectives)⁴³ gives some discretion for fund managers in determining how to deal with the onerous and controversial rules. Despite the application of a more tailor-made regime it is fair to say that the AIFMD remains full of pitfalls, particularly due to the lack of guidance about when 'inappropriate' rules can be ignored.

One must thus conclude that the 'venture capital exemption' under the Dodd-Frank Act is better tailored to industry specific needs and expectations than the AIFMD. From a transaction cost perspective, the exemptions for US venture capitalists are broader than under the AIFMD. However, it should also be noted that contrary to the Dodd-Frank Act, the application of the AIFMD might actually benefit venture capital fund managers in Europe. That is to say that if European venture capital fund managers are exempted, they still have to deal with the costly and cumbersome fragmentation of the regulatory framework in Europe. This clearly leads to the preliminary conclusion that European fund managers would be better off with a tailor-made and more proportional regulation that (1) offers the fund managers the possibility of obtaining a European passport without (2) having to comply with provisions that are clearly not designed with venture capital in mind. This brings us to

38 The AIFMD defines small and medium-sized enterprises within the meaning of Article 2(1) of the Annex to Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises. See Article 26(2)(a) of the AIFMD.

39 See Articles 26 to 29 of the AIFMD.

40 See Article 30 of the AIFMD.

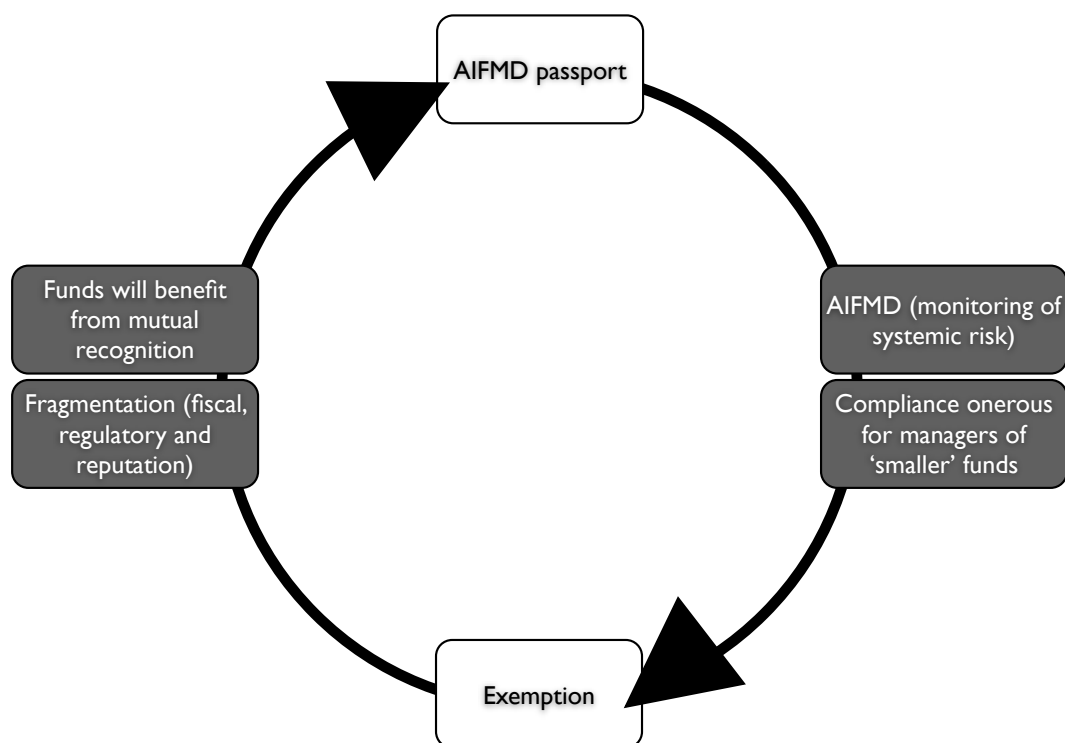
41 See Article 21(3) second subparagraph of the AIFMD.

42 See Article 16(1) of the AIFMD.

43 See Recital 94 of the AIFMD.

the proposed Regulations on European Venture Capital Funds that the European Commission first published on 7 December 2011.

Figure 1: The Vicious Circle of AIFMD



2.2 The 2011 Proposal for the European Venture Capital Funds Regulation

The proposed Regulation on European Venture Capital Funds makes it possible for venture capital fund managers to obtain a European passport if their assets under management do not exceed EUR 500 million.⁴⁴ This passport would be available to venture capital funds that (1) invest at least 70% of their committed capital as equity or quasi-equity in non-listed SMEs, and (2) are unleveraged in the sense that they do not invest more capital than that committed by their investors.⁴⁵ Figure 2 gives an overview of the application process. In order to be able to use the ‘European Venture Capital Fund’ label and to obtain the EU passport for marketing venture capital fund investments across the European Union, managers must inform the competent authorities of their home member state.⁴⁶ After the registration has been granted, the manager may start marketing its funds’ interests to professional investors in other member states.⁴⁷

⁴⁴ In which case the AIFMD applies. See Article 2(1) of the Proposal for a Regulation on European Venture Capital Funds (“Regulation” or “REVCF”). See also Recital 5 of the Regulation.

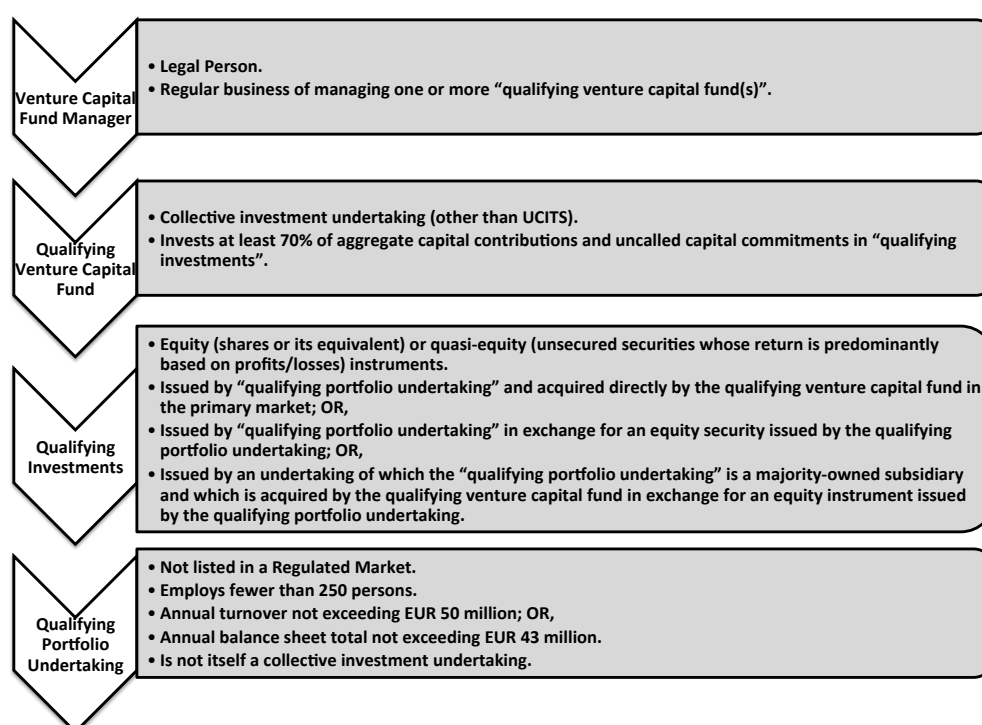
⁴⁵ See Articles 3(a) and 5(1) and (2) of the Regulation.

⁴⁶ See Article 13 of the Regulation.

⁴⁷ See Article 6 of the Regulation.

One of the distinguishing features of the Regulation is the application of a single ‘tailor-made’ rulebook. By offering minimum standards of disclosure and transparency, the rulebook intends to promote confidence in the venture capital market which, in turn, may lead to more venture capital being available to emerging growth companies. Under the Regulation, the venture capitalists are obliged to submit annual reports regarding each managed (and qualified) fund to the competent authorities of their home member state. These reports must contain information about the composition of the portfolio companies of the funds as well as audited financial statements in accordance with generally accepted reporting standards. The annual reports shall also be made available to investors on request.⁴⁸ Finally, managers must make sure that certain information be disclosed to investors prior to their investment decision in the fund, such as the identity of the manager and other service providers, the investment strategy and policy, the fund’s risk profile, the valuation procedures of the fund and of its assets, the manager’s remuneration package and the historical performance of the fund (if available).⁴⁹

Figure 2: An Overview of the Regulation on European Venture Capital Funds



Since the rulebook could to a certain extent be considered as a ‘codification’ of the existing best practices in the industry in Europe, there is no doubt that in light of restoring the workings of the venture capital cycle, the Regulation is a more effective measure than the more stringent AIFMD (See

⁴⁸ See, for all, Article 11 of the Regulation.

⁴⁹ See Article 12 of the Regulation.

also Table 1). However, the question arises if the Regulation will eventually support the emergence and development of a robust venture capital industry in Europe. This question has become even more important after the European Parliament issued its draft report on the Regulation in February 2012.⁵⁰

Table 1: Comparison between AIFMD and the Regulation on European Venture Capital Funds (“REVCF”)

Categories of Rules	AIFMD	REVCF
Authorization and/or Registration Procedures	All AIFMs managing AIFs must apply for authorization with the authorities of their home MS (Art. 6 and 7 AIFMD). Disclosure of information concerning the AIFM, its members/shareholders, the managers of the AIFM, the program of activity and structure of the AIFM, remuneration policies and delegation/sub-delegation of functions (Art. 7(2) AIFMD), the AIFs, their investment strategies, leverage policies, risk profiles, countries of establishment, instruments of incorporation, appointment of depositaries and the additional information of Art. 23(1) AIFMD (Art. 7(3) AIFMD).	VC fund managers willing to use the designation EVCF and the EU passport must register with the authorities of their home MS. The following information must be supplied: (i) identity of persons managing QVCFs; (ii) identity of QVCFs whose units/shares will be marketed and their investment strategies; (iii) a program of compliance with the requirements of the EVCFR; and (iv) a list of MS where the VC fund manager will market each QVCF (Art. 13(1) REVCF).
Initial Capital and Own Funds	For internally managed AIFs: at least EUR 300.000,- (Art. 9(1) AIFMD). For AIFs with an external manager: at least EUR 125.000,- (Art. 9(2) AIFMD). If the value of the portfolios managed by the AIFM exceeds EUR 250 million: additional amount equal to 0.02% of the value of the difference between EUR 250 million and the total value of the portfolios of AIFs managed by such AIFM (Art. 9(3) AIFMD).	VC fund managers shall have, at all times, <i>sufficient</i> own funds (Art. 9 REVCF).
Operating Conditions	(i) Fiduciary duties of AIFMs towards AIFs and their investors; (ii) restrictive remuneration policies; (iii) duty to identify, prevent and disclose conflicts of interest; (iv) duty to establish effective risk management systems; (v) strict rules on valuation and appointment of an internal/external valuer; (vi) strict rules on delegation/sub-delegation of functions; (vii) appointment of depositary for each AIF whose function’s delegation is restricted (Arts. 12 to 21 AIFMD).	(i) Leverage prohibited; (ii) no more than 30% of fund’s capital is used to acquire assets other than “qualifying investments”; (iii) marketing of units/shares of QVCFs only to professional investors and other kinds of sophisticated investors; (iv) fiduciary duties for VC fund managers; (v) duty to avoid, identify and disclose conflicts of interest; (vi) rules on valuation defined contractually by the parties to the QVCF (Arts. 5 to 10 REVCF).

⁵⁰ See European Parliament, Committee on Economic and Monetary Affairs, Draft Report on the proposal for a regulation of the European Parliament and of the Council on European Venture Capital Funds, 2011/0417(COD), 29 February 2012; European Parliament, Committee on Economic and Monetary Affairs, Amendments 35-149, Draft Report on the proposal for a regulation of the European Parliament and of the Council on European Venture Capital Funds, 2011/0417(COD), 29 March 2012. See also [http://parltrack.euwiki.org/dossier/2011/0417\(COD\)](http://parltrack.euwiki.org/dossier/2011/0417(COD)) (last accessed 27 July 2012).

Transparency Requirements	(i) Audited annual report with audited financial statements for each managed AIF, to be disclosed to each of AIF's investors and to authorities of home MS of the AIFM (and of the AIF if applicable); (ii) pre-investment disclosure towards prospective investors of all material information items concerning the managed AIF; and, (iii) regular reporting duties to authorities of AIFM's home MS on the markets and instruments in which it deals and the principal exposures and most important concentrations of each managed AIF (Arts. 22 to 24 AIFMD).	(i) Annual report per QVCF, with description of portfolio of QVCF and activities, and the QVCFs' audited financial accounts, to be provided to the authorities of the VC fund manager's home MS, and to the investors, upon the latter's request; (ii) pre-investment disclosure towards prospective investors of all material information items concerning the managed QVCF (Arts. 11 and 12 REVCF).
Rules on Fund Managers managing specific types of AIF	Exemption of AIFMs managing AIFs that acquire control of non-listed companies that are SMEs (Art. 26(2)(a) AIFMD). AIFMs managing VC funds exempted.	None.

2.3 The 2012 European Parliament Report on the Proposal for the European Venture Capital Funds Regulation

In a draft report on the proposal for the Regulation on European Venture Capital Funds, the European Parliament, through its Committee on Economic and Monetary Affairs, has proposed to make it more difficult for investment funds to obtain the European Venture Capital Fund label. For instance, in order to reduce the risk of misappropriation of the passport system, the European Parliament has suggested including a requirement that 'qualifying portfolio undertakings' should be younger than five years. The focus on investments in companies in the very early stages of their development is in line with the traditional 'venture capital cycle' idea.⁵¹ Unfortunately, this cannot be said for the more worrisome proposal to apply AIFMD requirements to European Venture Capital Funds. It appears that the European Parliament, supported by the opinions of the European Central Bank and the European Economic and Social Committee,⁵² is more concerned about whether the proposal makes sense from a regulatory perspective rather than how the Regulation could harmonize venture capital fundraising and, more importantly, spur venture capital investments in emerging growth companies. Indeed, the draft report wrongfully states that the inclusion of the 'depository principle', which is integrated in the UCITS Directive and the AIFMD, is necessary in order to ensure the continuity of the European Community's regulatory framework.⁵³

⁵¹ See Tereza Tykvová, Mariela Borelli and Tim-Alexander Kroencke, Potential of Venture Capital in the European Union, European Parliament, Directorate General for Internal Policies, Policy Department A: Economic and Scientific Policy, Industry, Research and Energy, February 2012. Unfortunately, this Study does not recognize the shortcomings of the traditional venture capital cycle in Europe.

⁵² See European Central Bank, Opinion of the European Central Bank on a proposal for a regulation of the European Parliament and of the Council on European Venture Capital Funds and on a proposal for a regulation of the European Parliament and of the Council on European Social Entrepreneurship Funds, CON.2012/32), 25 April 2012; European Economic and Social Committee, Opinion of the EESC on the Proposal for a Regulation of the European Parliament and of the Council on European Venture Capital Funds, 2012/C 191/13, 29 June 2012.

⁵³ In order to reduce the problems arising from information asymmetries, the AIFMD requires AIF's assets to be safe-kept by an independent depository, which is subject to high liability standards. See Article 21 of the AIFMD.

As discussed in the previous Section, the 2011 draft of the Regulation did not include the ‘depository principle’. The European Commission acknowledged that the application of this stringent AIFMD requirement, under which an independent body would be entrusted with safe-keeping and monitoring of the funds’ assets, would have a detrimental effect on the development of the venture capital industry in Europe. Recall that the Regulation was initially introduced to ‘defragment’ the venture capital industry by creating a truly European ecosystem in which fundraising activities and investments in start-up companies would not be hampered by regulatory differences and specific market requirements. The European Venture Capital Association (EVCA) supports the Commission’s view.⁵⁴ It is, of course, understandable that in times of economic crisis, policymakers and regulators feel responsible for safeguarding the stability of the financial market, protecting investors and preventing market abuse. However, according to the EVCA, they should be careful not to frame regulation in a way that is unproductive and even destructive. In an open letter to the European Parliament, co-signed by more than 180 venture capital fund managers,⁵⁵ the EVCA posited three arguments against the application of the depository principle. Firstly, it was argued that a depository would not provide any additional investor protection. Secondly, since there are currently no third-party depository services to venture capital funds, the costs of the new Regulation would become exorbitantly high. Thirdly, an obligation to appoint a depository would practically mean that venture capital fund managers in Europe would not apply for a pan-European passport and benefit from a defragmented, pan-European, venture capital market.

It is thus commendable that the Danish EU Presidency, despite the protectionist view of policymakers and regulators, was able to reach a compromise concerning the European Venture Capital Regulation on 28 June 2012.⁵⁶ Convinced about the need for a venture capital industry, rapporteurs of the European Parliament agreed to drop the depository requirement in exchange for (1) a review clause under which it is possible to revise the Regulation after four years if the European Venture Capital Fund label is misused by other investment funds, (2) the inclusion of strengthened annual audit requirements, and (3) a revocation clause that gives national authorities the power to withdraw the European Venture Capital Fund label in case of non-compliance.⁵⁷ The European Parliament was also willing to give up the age requirement for qualifying portfolio undertakings. Even though the Council and the Parliament will only officially adopt the compromise Regulation by the end of 2012,⁵⁸ the regulatory compromise was heralded as a breakthrough by the European venture capital industry.

⁵⁴ See EVCA (European Venture Capital Association) at www.evca.eu (stating that the proposed venture capital regime should not be destroyed by an unjustified and disproportionate burden).

⁵⁵ See http://www.evca.eu/uploadedFiles/News1/News_Items/2012-06-20_EVCFR-Depository-MEP_Lamberts.pdf.

⁵⁶ See <http://eu2012.dk/en/NewsList/Juni/Uge-26/Funds>.

⁵⁷ See Ophélie Spanneut, *Venture Capital and Social Entrepreneurship: Agreement struck at last on European fund label*, *EuroPolitics*, 29 June 2012.

⁵⁸ See Máire Geoghegan-Quinn, *The European perspective on innovation / Improving the landscape for venture capital*, Speech at the Global Venture Capital Congress 2012, Dublin, 5 October 2012.

Indeed, an arrangement to allow venture capital funds to solicit investors throughout the European Union does not seem particularly controversial. In fact, given the design of the European Union as an internal market where one has (or should have) free movement of goods, services, labour and capital, it is hard to imagine why the European Union still has a fragmented venture capital industry. If venture capital fund managers are free to operate cross-border in the European Union, then presumably they should be free to solicit investors under a pan-European passport regime without having to comply with different national legislations. The question remains, however, whether the Regulation, which aims to remove the legal and regulatory barriers in the venture capital market in Europe, will be able to make a significant contribution to the development of a robust venture capital industry. What should we expect? These questions will be answered in the next Section.

3. The Evolution of Venture Capital Funds

If the venture capital industry were to benefit from the harmonizing effect of the proposed Regulation, we should expect that more and bigger funds make more and more diversified investments in start-up companies throughout the European Union. Yet, the expectations of the Regulation should not be set too high. It should be noted that in their enthusiasm for the regulatory achievement, policymakers, venture capitalists and their advisors may easily fall prey to what is called ‘optimism bias’.⁵⁹ In the domain of venture capital, optimism bias has the potential to cloud other important and relevant issues. For instance, the proposed Regulation does not remove the tax obstacles to cross-border fundraising and investment strategies. These obstacles were already discussed in a 2009 expert group report.⁶⁰ The expert group, organized by the Commission’s Directorate General for Taxation and Customs Union, distinguished two major obstacles that hinder cross-border venture capital fund activities: (1) investing in foreign companies could create a taxable presence (‘permanent establishment’) of the fund in the member state of investment and (2) the different fiscal treatment of funds (transparent/non transparent) in different member states could result in thorny double taxation issues. Clearly, the European-wide regulatory approach to venture capital funds could serve as a good starting point for discussions among tax regulators to address these obstacles. In fact, it is expected that a new report on the tax obstacles will appear in 2012.⁶¹ Although this report will ideally lead to acceptable solutions during the course of 2013,⁶² the principles of subsidiarity and proportionality (which put severe limitations on

⁵⁹ See Section 1 above.

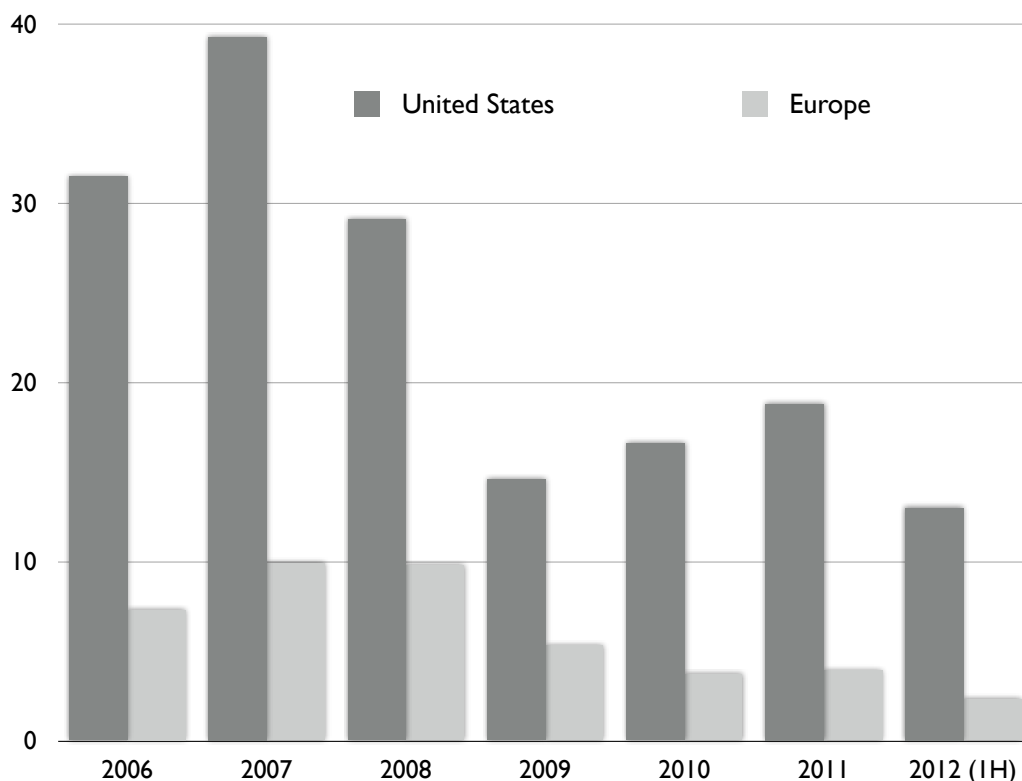
⁶⁰ See European Commission, Report of Expert Group on removing tax obstacles to cross-border Venture Capital Investments, 2009. See also European Commission, Cross-border venture capital in the European Union, European Commission work on removing obstacles, December 2009; European Commission, Expert group report on removing obstacles to cross-border investments by venture capital funds, COM(2007) 853 final, Brussels, 21-12-2007.

⁶¹ See European Commission, Public Consultation Paper, Problems that arise in the direct tax field when venture capital is invested across borders, 3 August 2012.

⁶² See European Commission, Proposal for a Regulation of the European Parliament and the Council on European Venture Capital Funds, COM(2011) 860 final, Brussels, 7-12-2011.

the regulatory competencies of European policymakers) are likely to prevent a quick and effective solution to the cross-border tax issues.⁶³

Figure 3: Venture Capital Fundraising (based on multiple closings) in Europe and the United States in US\$ (M)



Source: Data from Dow Jones VentureSource

But even if European policymakers are able to introduce a common legal and fiscal treatment for venture capital funds, it is unlikely that the fundraising gaps in the venture capital cycle will be easily bridged. Indeed, the evolution of the venture capital industry has led to profound changes in the fundraising landscape. Most importantly, we observe a significant drop in fundraising on a global scale with 133 funds raising an aggregate amount of \$32.3bn (and holding a final close) in 2011, down from \$63.6bn across 259 funds holding a final close in 2007.⁶⁴ At the same time, raising the desired fund size has taken considerably longer for venture capital funds that closed in 2011. In 2007, the average time to the final closing of a fund was approximately 12 months. In 2011, it took

⁶³ See William W. Bratton and Joseph A. McCahery, Tax Coordination and Tax Competition in the European Union: Evaluating the Code of Conduct on Business Taxation, *Common Market Law Review*, vol. 38, 2001. Interestingly, tax issues also appear to delay the ‘negotiations’ on the European Venture Capital Fund Regulation. See also *supra*, n. 58: “Negotiations are still progressing on one remaining issue - whether to exclude from the “passport” funds that are domiciled in tax havens or that invest in companies based in tax havens - and this issue could well be resolved by the end of this year.”

⁶⁴ Data derived from data provider Preqin.

approximately 18.5 months to reach a final closing.⁶⁵ The dramatic change in pre-financial crisis fundraising levels compared to post-financial crisis fundraising levels is mainly triggered by the fact that institutional investors started to massively shy away from investing in venture capital funds.⁶⁶ As reflected in Figure 3, fundraising is particularly challenging for venture capital funds in Europe.

The reasons for this are simple. Firstly, since the burst of the dot-com bubble in 2000-01, more venture capital has been invested in start-up companies than returned to the investors in venture capital funds, making it a relatively unattractive asset class for institutional investors.⁶⁷ The fact that payouts to venture capital fund investors show an 80% drop in the first half of 2011 compared with the same period in 2000 is a good example of the underperformance of the venture capital industry.⁶⁸ Of course, there are funds that significantly outperform the public market, creating high-profile growth and exit opportunities in very successful start-up companies.⁶⁹ However, selecting the best-performing funds (with proven expertise and successful track records) is a challenging task.⁷⁰ The fact that venture capital funds tend to lack transparency regarding their actual performance is seen as the second reason for institutional investors' avoiding new venture capital investments.⁷¹ Funds often use the internal rate of return (IRR) as a financial performance measure, but recent studies show that this measure can be inaccurate, misleading and prone to manipulation.⁷² Institutional investors must therefore also rely on alternative performance measures when making investment decisions, such as investment multiples, growth prospects and other economic indicators. This brings us to the third reason that explains why institutional investors are increasingly nervous about the prospects of investments in high potential growth companies: the due diligence process and comparative financial analysis of fund performance adds to the transaction costs and significantly slows down the investment decision-making process.⁷³ Finally, there is a fourth reason why institutional investors have become reluctant to invest in venture capital funds. Institutional investors are sometimes prohibited to make risky investments as a result of increased regulation.⁷⁴ It could be argued that the over-regulated and fragmented environment explains why venture capital fundraising is at a historical low in Europe. In this respect, the prospects are not

65 See also Preqin Research Report, 2011 Private Equity Fundraising.

66 See Udayan Gupta, 'Why institutional investors are turning down venture funds', *Institutional Investor*, 21 September 2010.

67 See Diane Mulcahy, Bill Weeks and Harold S. Bradley, "We Have Met the Enemy... And He Is Us", *Lessons from Twenty Years of the Kaufmann Foundation's Investments in Venture Capital funds and the Triumph of Hope over Experience*, Ewing Marion Kauffman Foundation, May 2012. See also Robert S. Harris, Tim Jenkinson and Steven N. Kaplan, *Private Equity Performance: What Do We Know?*, Working Paper, 18 February 2012; Felix Salmon, *How venture capital is broken*, Reuters, 7 May 2012.

68 See Amy Cortese, *Venture Capital, Withering and Dying*, *The New York Times*, 21 October 2011.

69 See for European examples, Hendrik Brandis and Jason Whitmire, 'Turning Venture Capital Data into Wisdom: Why returns in Europe are now outpacing the U.S.', *Earlybird Europe Venture Capital Report*, 28 July 2011.

70 See GO4Venture, 'Monthly European Technology Venture Capital Bulletin', September 2010. A recent study shows that institutional investors lost faith in the European venture capital industry. Only 3% believe that the European venture capital funds will be able to provide their investors with strong return over the next decade. See Collier Capital, 'Global Private Equity Barometer Winter 2010-11', 18 January 2011.

71 See Arleen Jacobius, *Institutional investors like venture capital again*, *Pensions & Investments*, 14 May 2012.

72 See Oliver Gottschlag, *The Historic Performance of PE: Average vs. Top Quartile Returns, Taking Stock after the Crisis*, PERACS, November 2010. See also Brain McLeod, *Should private equity investors trust IRR?*, *Asian Venture Capital Journal*, 24 August 2011.

73 See Igor Sill, *The Changing Venture Capital Landscape*, Sand Hill, 20 March 2012.

74 See EVCA, *EU Regulation Will Destroy Key Source of Finance For Innovation*, 15 March 2010.

very encouraging. Investors' anticipation of several 'forthcoming' regulations, such as Basel III and Solvency II,⁷⁵ which contain restrictions on the ability of banks and insurance companies to make investments in the risky venture capital business, already appear to have a hampering effect on the industry's development.⁷⁶

It is thus fair to conclude that the institutional investors' lack of appetite in the venture capital asset class has depressing consequences for the venture capital industry as a whole. So, is the venture capital cycle broken? Maybe it looks that way, but actually the answer is that the fundraising part of the venture capital cycle works differently. Indeed, we have several observations that suggest that the fundraising process has undergone a 'Darwinian' evolution in the post-financial crisis era,⁷⁷ making the European Venture Capital Funds Regulation less relevant for the development of the venture capital industry in Europe. Firstly, there is 'survival of the fittest' evidence that the number of active venture capital funds has significantly declined in the last five years.⁷⁸ Apparently, the financial crisis and the uncertain economic outlook have caused many managers to close offices or shut down completely. An increasing number of venture capital firms hopes for a better future by extending the duration of their funds.⁷⁹ Only high quality funds seem to have a reasonable chance of receiving continuous funding for their activities. Indeed, institutional investors have largely chosen to invest only in the best performing and most highly reputed funds. Secondly, empirical research shows that institutional investors take an increasingly active approach to the management of the funds, evidenced by the inclusion of more investor-favourable terms and conditions in the venture capital fund agreements.⁸⁰ It is interesting to see that also the high quality fund managers are sometimes put in weaker bargaining positions.⁸¹ Finally, new 'breeds' of active as well as patient investors are showing an increased interest in the venture capital industry. Looking forward, we see family offices, corporate venture capital groups, angels, other venture capitalists and private equity and hedge funds playing a

75 Under Basel III, banks have to respect certain capital buffers, which make it more difficult for them to invest in venture capital funds. See, for instance, Ronald D. Orol, Fed moves forward with Basel III capital rules, *The Wall Street Journal* (MarketWatch), 7 June 2012. Solvency II (Directive 2009/138/EC) targets insurance and reinsurance companies. Although it is too early to predict with certitude, the capital adequacy rules as well as the risk management standards will probably have some effect on insurance companies' investment decisions. See Fimeris Global LP Allocation Survey Q4 2011. The new regulations have not yet entered into force. However, in anticipation of the new standards, insurance companies are already planning changes to their business models. Venture capital fund managers are therefore recommended to make sure that they are able to provide the potential investors with the necessary risk and governance information. See, generally, BVCA, *Gearing up for Solvency II*, Research Note, Number 12, 18 July 2011.

76 See Jos B. Peeters, European Parliament ECON Public Hearing on EU Social Entrepreneurship Funds and EU Venture Capital Funds, 20 March 2012. See also Anneken Tappe, regulation update: Basel III, *unquote.com*, 23 March 2012.

77 See also Mike Kwatinetz and Cameron Lester, Investing at the Bottom of the Venture Capital Cycle, *The New York Times* (DealBook), 14 March 2011 (indicating that the scarcity of capital created a Darwinian effect with a new breed of start-ups in which innovation-induced growth rather than capital-induced growth prevails).

78 See John Backus and Todd Hixon, Venture capital's new golden age, *CNNMoney*, 21 May 2012.

79 Empirical research shows that in the wake of the financial crisis 85% of the surveyed institutional investors had received a request for a fund extension over a one year period. See Private Equity International, *Institutional Investor Sentiment Survey*, July 2012.

80 See Nicholas Donato, LPs demanding greater clarity in fund terms, Private Equity International, 16 August 2011.

81 Survey: LPs get tough on management fees, Private Equity International, 7 August 2012.

more active role as venture capital fund investors in both Europe and the United States.⁸² We spell out the details of the Darwinian developments in the venture capital industry below.

3.1 Survival of the Fittest

3.1.1 The United States

The hypothesis that institutional investors are mainly interested in venture capital firms that have outstanding track records is confirmed by the recent fundraising trends in the United States.⁸³ Institutional investors seem convinced that some US venture capital firms will again be able to produce strong results from backing high-potential technology companies.⁸⁴ Figure 3 seems to indicate that the disappointing IPO performances, as we have seen with Groupon, Zynga and Facebook in November 2011, December 2011 and May 2012 respectively, do not necessarily negatively affect investors' interest, provided, of course, that the IPO market is strong enough to make a recovery.⁸⁵ In fact, we see a 10% increase in venture capital fundraising in the first half of 2012 – based on new capital commitments – compared to the same period in 2011.⁸⁶ At the same time, we see an 8% decline in the number of funds that were able to attract capital commitments.

The conclusion could be that institutional investors increasingly prefer to pour money into the smaller group of well-established, high quality funds. This is reflected in Figure 4, which shows an increasing ratio of follow-on funds to new funds (in which new funds are defined as the first fund of a new venture capital management company). It is also confirmed in practice that particularly the top firms are benefiting from the renewed interest of institutional investors in venture capital. For instance, approximately 80% of the capital raised was committed to 'only' 11 reputable funds in the first half of 2012. The current trend leads to the elimination of the 'weakest' funds, which makes sense from a Darwinian perspective. The accumulation of more capital in fewer venture capital funds also explains why the median fund size is increasing in 2012. According to recent data, based on final closings and for funds greater than \$20 million, the median fund size of US funds was \$150 million in the first half

82 See James Mawson, Corporate Venturing in the UK, RSA Projects, 2012. See also Jonathan Loules, UK risks losing vital corporate funding, *The Financial Times*, 20 July 2012; John Taylor, Corporate Venture Capital Remained Strong in Q2 2012, *Research and Trends, NVCACCESS*, 26 July 2012.

83 See Russ Garland, U.S. Venture Fundraising Still Rules by a Few Firms, Third-Quarter Data Shows, *The Wall Street Journal (Venture Capital Dispatch)*, 8 October 2012.

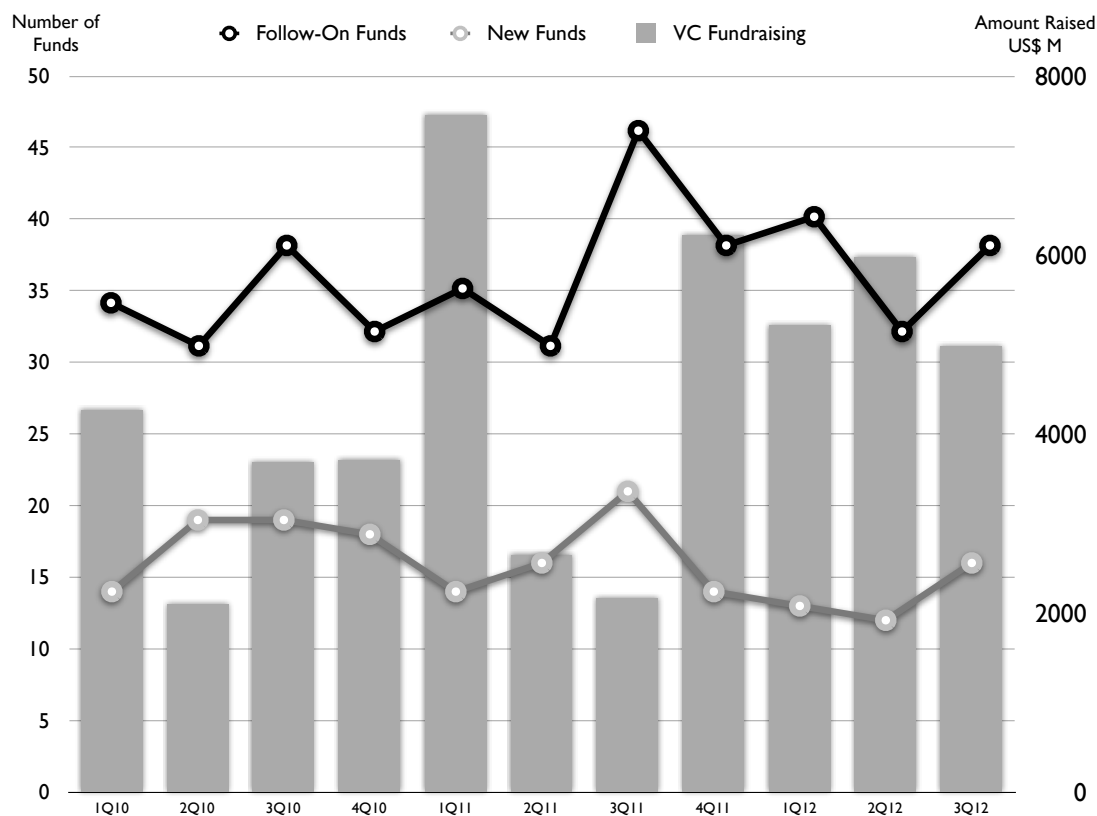
84 See *supra*, n. 71.

85 Some believe that Facebook's (and Zynga's and Groupon's) IPO debacle will result in a decline of the number of IPOs. See David Futelle, Has Facebook Jinxed the IPO Market for Everyone?, *Time Business*, 24 May 2012. However, the significant number of great IPO performers as well as the relatively large number of companies in the IPO pipeline indicates that there is no reason to panic. See Thomson Reuters and the National Venture Capital Association, News Release, IPO Market Stalls in Second Quarter Despite Largest Venture-Backed Offering on Record, 2 July 2012; Peter Delevett, Silicon Valley hopes on new wave of IPOs, *The Republic*, 11 July 2012. See also Joseph A. McCahery and Erik P.M. Vermeulen, *Corporate Governance, IPOs and Economic Growth*, Working Paper, Forthcoming 2012.

86 Thomson Reuters – National Venture Capital Association, Venture Capital Firms Raised \$4.9 Billion in Q1 2012, News Release, 9 April 2012; Thomson Reuters – National Venture Capital Association, Venture Capital Firms Raised \$5.9 Billion in Q2 2012, News Release, 9 July 2012.

of 2012. The median fund size of venture capital funds in 2010 and 2011 was \$121 million and \$140 million respectively.⁸⁷

Figure 4: Fundraising in the United States (based on new capital commitments) (\$M)



Source: Data from Thomson Reuters/National Venture Capital Association

3.1.2 Europe

The ‘survival-of-the-fittest’ trend is even more apparent in Europe. Concerns about the over-regulated environment, alongside the ongoing financial crisis, seriously hamper the venture capital fundraising process. The consequences are quite dramatic. Besides the drop in fundraising, Europe also experiences a shakeout in the number of active venture capital firms. Approximately 1600 venture capital firms were active in Europe in 1999.⁸⁸ Compare this number to the 558 EU firms that have participated – through one or more venture capital funds – in investment rounds in emerging growth companies in the period 2010 to the first half of 2012.⁸⁹ We could argue that the European venture capital industry is in crisis. The devastating effects of the European economic downturn become even more evident when we consider that only 4% of these firms participated in more than 20 financing rounds in the period 2010 to the first half of 2012. According to data provider Preqin Venture Deals

⁸⁷ Data derived from data provider Dow Jones VentureSource.

⁸⁸ See supra, n. 69.

⁸⁹ Data derived from Preqin Venture Deals Analyst.

Analyst, the High-Tech Gründerfonds was the most active venture capital firm in the European Union. The public-private partnership that was set up to foster entrepreneurship in Germany invested in 118 start-up companies in this period (2010 to September 2012). This number is moderate compared to the five most active venture capital funds in the United States (see Table 2). The differences are even more significant when we compare the aggregate deal value.

Table 2: 5 Most Active Venture Capital Firms in the United States (by number of deals from 2010 to September 2012)

Name	No. of Investments	Aggregate Deal Value (\$M)
Kleiner Perkins Caufield & Byers	292	8,719.01
Accel Partners	283	4,925.87
Sequoia Capital	282	4,605.15
New Enterprise Associates	268	5,711.07
Intel Capital	251	3,501.04
<i>High Tech Gründerfonds</i>	<i>118</i>	<i>164.53</i>

Source: Data from Preqin – Venture Deals Analyst

Despite the persistent venture capital gap between the venture capital industries in Europe and the United States,⁹⁰ there are clear signs of recovery in Europe. Fundraising – based on multiple closings – more than doubled in the first half of 2012 compared to the same period in 2011 (from \$1.1 billion to \$2.3 billion).⁹¹ Also, the median fund size for funds greater than \$20 million has increased from almost \$ 52 million in 2006 to \$100 million in 2011. This change may have a massive beneficial effect on the venture capital industry in Europe. Indeed, recent empirical work seems to provide some support for the argument that there is a positive correlation between the IRR and the total amount of committed capital.⁹² A good rule of thumb is that the optimal fund size for a venture capital fund is between \$100 million and \$400 million. In this view, it is argued that high performing venture capitalists that are able to raise funds of more than \$500 million have often become a victim of their own success in the United States.⁹³ It appears that venture capitalists that are able to raise funds beyond their optimal size (more than \$500 million) are often struggling with maintaining a strong performance. In practice, this means that more than 80% of the biggest funds fail to deliver returns that outperform the stock market.⁹⁴ There are several possible explanations for this remarkable

⁹⁰ See supra, n. 58.

⁹¹ According to information from data provider DowJones VentureSource.

⁹² See Josh Lerner, Ann Leamon and Felda Hardyman, *Venture Capital, Private Equity, and the Financing of Entrepreneurship*, Wiley-VCH, 2012.

⁹³ See Steven N. Kaplan and Josh Lerner, *It Ain't Broke: The Past, Present, and Future of Venture Capital*, *Journal of Applied Corporate Finance*, Vol. 22, 2010.

⁹⁴ See supra n. 67.

observation. Venture capitalists that have to put too much capital at work often find it difficult to find appropriate investment opportunities. They tend to focus on start-ups with significant capital needs and exit value expectations, making it more difficult to abandon a disappointing investment. Obviously, a larger fund needs larger exists in order to be successful.⁹⁵ But perhaps most intriguing is the problem with the payment of the 2% annual management fee. It is argued that the traditional compensation arrangement does not provide the managers of the biggest funds with sufficient incentives to select the most promising and profitable investments. This argument is in line with empirical research that shows that the bigger the fund, the higher the fixed income will be, the less important the fund performance will become.⁹⁶

Table 3: Exits (Initial Public Offerings and Trade Sales of \$100+ million) in Europe and the United States (\$M)

United States	Average	Minimum	Maximum	Median
2010	333	100	2,250 – Trade Sale	216
2011	308	100	1,700 – Trade Sale	234
2012 (1H)	608	100	16,000 – IPO	203
2012 (1H) Excluding Facebook	294	100	1,200 – Trade Sale	200
Europe	Average	Minimum	Maximum	Median
2010	262	172	330 – Trade Sale	255
2011	196	100	401 – Trade Sale	140
2012 (1H)	263	100	650 – Trade Sale	155

Source: Data from Preqin – Venture Deals Analyst

If we agree that fund size matters, we may conclude that the state of the ‘post-financial crisis’ venture capital industry in Europe appears to be more optimistic and attractive than the environment in the United States.⁹⁷ Due to their optimal size, Europe’s top venture capital firms, which are also fewer in number, are arguably in a better position to find high quality investment opportunities at relatively low pre-money valuations. This explains why, if we use exit values as a measure of success, the top European venture capitalists can match with the best performing firms in the United States. True, Table 3 shows that the average exit value in Europe and the United States for deals that have an exit value of at least \$100 million are converging in 2012. Still, the differences between the venture capital industries remain remarkable. For instance, the number of deals, the aggregate deal value as well as the number of successful exits in Europe is in no comparison to the many investments, trade sales and IPOs in the United States (see Figure 5). An explanation for the persistent differences is that the industries, which evolved along different paths, show a different response to increased uncertainty in

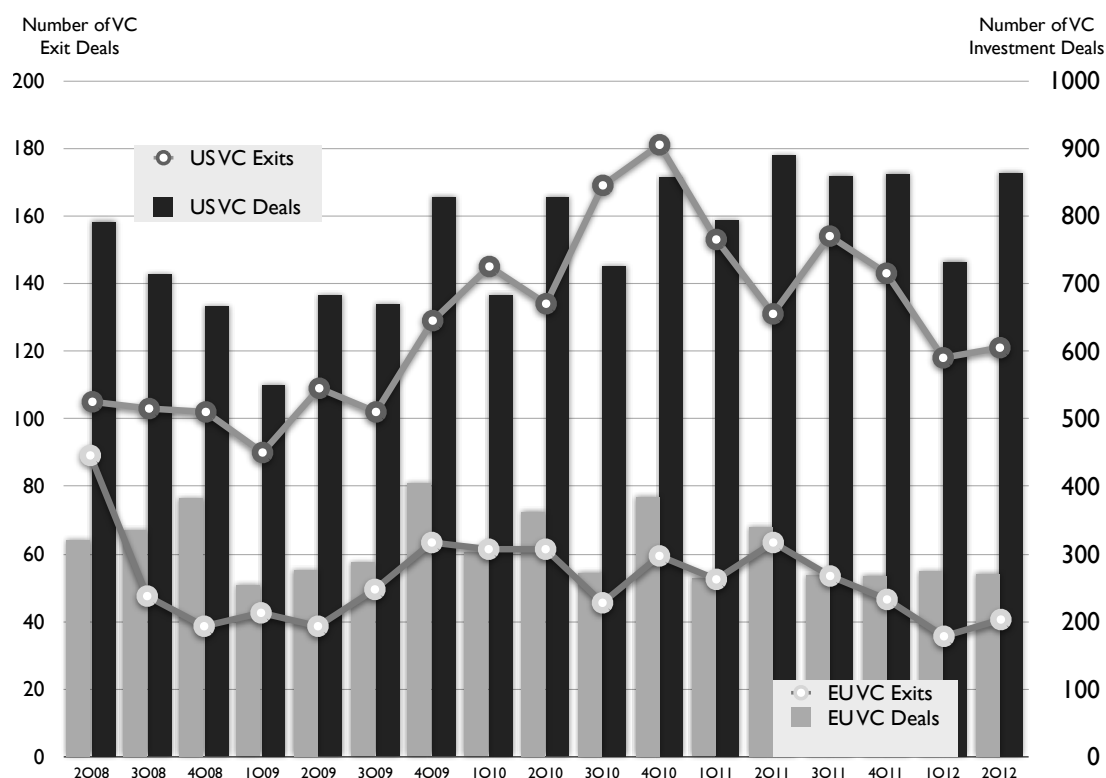
⁹⁵ See Tom Tunguz (Redpoint Ventures), Fund Size Matters When Picking a VC: How to Align VC and Founder Incentives, ex post facto, 1 April 2011.

⁹⁶ See supra, n. 67.

⁹⁷ See Douglas Cumming and Sofia Johan, Is Venture Capital in Crisis?, World Economic Review, forthcoming 2012.

the aftermath of the economic downturn. In the United States, for instance, Silicon Valley's entrepreneurial success can largely be attributed to the venture capital culture and interactive networks among institutional investors, venture capitalists, entrepreneurs and their respective advisors that has for long made the 'venture capital cycle' self-propelling.⁹⁸ Clearly, this culture makes the venture capital industry in the United States more resilient to financial shocks than Europe.⁹⁹ This cultural difference is perhaps most obvious in the area of venture capital fundraising. Yet, as we will see, in the next subsection, the established culture is not sufficient anymore to ensure a steady supply and demand of venture capital. The fundraising process on both sides of the Atlantic is in crisis.

Figure 5: Venture Capital Deals and Exits in Europe and the United States



Source: Data from Dow Jones VentureSource

3.1.3 Fundraising Challenges in Europe and the United States

Fundraising data indicates that venture capital funds in Europe are increasingly dependent on government support. In their efforts to establish a sustainable ecosystem – and largely because European institutional investors, particularly banks and insurance companies, remain skeptical about the industry – governments have become the main post-financial crisis investors in Europe. According to data from the European Venture Capital Association, 39.1% of the €4.1 billion that was raised by

⁹⁸ See Victor Hwang, To replicate Silicon Valley's success, focus on culture, 26 April 2012.

⁹⁹ See Grace Nasri, Venture capitalists focus on later stages, but Silicon Valley still rules, VentureBeat, 20 December 2011.

European venture capitalists in 2011 came from government agencies.¹⁰⁰ In 2007, this percentage was 9.9 (of €8.2 billion). Investments – by the European Investment Bank, the European Investment Fund and the European Commission’s resources – account for approximately 23% of the total capital raised in 2011.¹⁰¹

It is generally acknowledged that governments have become a very attractive partner in the venture capital industry in Europe. What is more important is that governments, by committing to a vast array of funds, bring trust into the venture capital industry, which is necessary to stimulate private sector investments.¹⁰² Recall that the US venture capital culture is built on trust and relationships that are missing in Europe. Still, it is important to realize that although government venture capital certainly has many beneficial effects,¹⁰³ governments cannot substitute for the lack of institutional investors’ commitments. Government-backed venture capital funds, for example, are still relatively small in number and often have a regional focus. Consider again the German High-Tech Gründerfonds. This German public-private partnership currently manages in excess of €550 million of committed capital in two funds (€272 in Fund I and €293.5 million in Fund II) and invests mainly in German emerging growth SMEs. This is understandable since the German Federal Ministry of Economics and Technology as well as KfW Banking Group could be viewed as the anchor investors in the available funds. But the picture of a regional focus does not seem to change if a fund’s capital is committed by European government agencies. In this respect, it is interesting to see that in 2011 more than 50% of the 42 funds that attracted investments from EU resources, such as the European Investment Fund, had a domestic focus.¹⁰⁴ And there are other ‘shortcomings’ of government venture capital to consider. A recent study suggests that venture capital funds that receive only a moderate fraction of government funding are in a better position to provide significant investors’ returns.¹⁰⁵ Extensive government support, however, most likely results in underperformance if non-financial objectives, such as contributing to structural/regional development policies, prevail.¹⁰⁶ A mix of government and private investors is thus crucial to come to a sustainable venture capital cycle in which there is a balance between the demand and supply of capital.

This is easier said than done. The dearth of private investors arguably makes European venture capital funds more concerned about competing for funds and promising investment opportunities rather than teaming up by joining together in a syndicate.¹⁰⁷ Obviously, the competing attitude will not

100 See The Economist, *Venturecrats*, 19 April 2012.

101 See European Investment Fund, *Annual Report 2011*.

102 See Joseph A. McCahery and Erik P.M. Vermeulen, *Venture Capital Beyond the Financial Crisis, How Corporate Venturing Boosts New Entrepreneurial Clusters (and Assists Governments in Their Innovation Efforts)*, *Capital Markets Law Journal*, Vol. 5, 2010. See also Section 3.3.2 of this paper.

103 See Katherine Steiner-Dicks, *Great intervention?*, *Private Equity Findings*, Spring-Summer 2010.

104 See *supra*, n. 101.

105 See James Brander, Qianqian Du and Thomas Hellmann, *Governments as Venture Capitalists: Striking the Right Balance*, in *Globalization of Alternative Investments, Working Papers Volume 3: The Global Economic Impact of Private Equity Report 2010*, World Economic Forum.

106 See Roger Kelly, *The Performance and Prospects of European Venture Capital*, EIF Research & Market Analysis, Working Paper 2011/09.

107 See also James Wilson, *German VCs hit back at falling confidence*, *Financial Times*, 23 January 2011.

improve the fundraising landscape in Europe. As we have seen, the effectiveness – and attractiveness – of a venture capital market depends centrally on the existence of strong, trust-based networks among venture capitalists.¹⁰⁸ These networks encourage fund managers to syndicate their investments. A syndicate is a collection of investors in a particular financing round. Obviously, these syndicates play a pivotal role in the working of the venture capital cycle. By syndicating their investments, venture capital firms are able to make more and also more diversified investments. The result is that more capital will become available for early and later stage rounds of financing. And there are other benefits. Syndicates mitigate a fund's investment risks. What is important in a syndicate is that more specific experience and expertise is brought together. Finally, in later stage (and less risky) rounds of financing, syndication strategies are often pursued by younger venture capital firms to gain experience for the future. To be sure, the practice of syndicating deals is employed in both Europe and the United States. Table 4 shows, however, that there are some important differences. Firstly, if we look at series A, B and C investments in the first half of 2012, we observe a higher percentage of deals with more than three syndication partners in the United States. Secondly, and more importantly, the number of syndicated deals is much higher in the United States (see the last column of Table 4). A possible explanation for the differences is that in a relatively small and declining – in terms of the 'survival of the fittest' trend – venture capital industry, fund managers may be reluctant to engage in syndication if it jeopardizes the diversification that their investors hope to achieve.¹⁰⁹

Table 4: Syndication in Series A, B and C deals in 1H 2012: Europe versus the United States

	No syndication	2 partners	3 partners	4 partners	5 partners	>5 partners	Percentage of total syndicated deals in dataset
US	25%	25%	19%	15%	9%	7%	85%
Europe	26%	32%	23%	11%	3%	5%	15%

Source: Data from Preqin – Venture Deals Analyst

This brings us again to the question whether it is reasonable to expect that the post-financial crisis reforms, such as the European Venture Capital Funds Regulation, can stimulate private sector investments in both new and follow-on funds? Optimists argue that the 'European Venture Capital Fund' label will not only help reduce uncertainty and information asymmetry in the venture capital

108 See Victor W. Hwang and Greg Horowitz, *The Rainforest, The Secret to Building the Next Silicon Valley*, Regenwald, 2012.

109 Here it should be noted that interviews with US venture capital fund managers indicated a similar concern. Clearly, the 'survival of the fittest' trend will make it more difficult to be involved in syndicated deals in the future. Indeed, the fact that institutional investors invest in fewer funds will increase the possibility of these investors backing the same start-up company.

industry,¹¹⁰ but also provide an international stamp of quality.¹¹¹ If they are correct, institutional and other investors will be more inclined to invest in venture capital funds that obtained a European passport. This will enable venture capitalists to raise more funds faster.

The Regulation could also contribute to the accessibility of venture capital for emerging growth companies. Consider the ‘venture capital cycle’ in Europe. Compared to the United States, it suffers from significant gaps, making it more difficult for SMEs to reach their growth potential.¹¹² The relatively low number of funds arguably creates a substantial ‘funding gap’ in the seed and early stages of a start-up firm’s development in terms of number of deals and amount invested. The funding gap is most serious in the later stages. Indeed, as reflected in Figure 6, the differences between Europe and the United States are particularly evident in these later stages of financing. The funding gap issue in Europe is exacerbated by the fact that geographical proximity is one of the factors determining investment decisions in the post-financial crisis era, making it more difficult for emerging growth companies to have access to foreign funds.¹¹³ Empirical research shows that in the period 2010 – 1H 2012 managers of European venture capital funds preferred to invest in domestic portfolio companies:¹¹⁴ 57% of the investments were made domestically. Only 17% of the investments were made in companies that were located in another European member state. A higher proportion was invested in the United States (approximately 20%) and Asia (approximately 4%). It appears that cross-border investments became less attractive in the wake of the financial crisis. Indeed, another empirical study shows that European venture capital funds had a more global investment approach before the crisis, when the majority of European funds had invested outside of their home market, particularly in the United States.¹¹⁵ The logic behind the reforms is that more fundraising opportunities will also make venture capital more accessible for emerging growth SMEs.

We claim, however, that the ‘improved fundraising’ view is too optimistic. To be sure, investors will most likely demand the registration as a ‘European Venture Capital Fund’. But this will generally be considered a formality that has no major impact on the private investors’ decisions to invest in a fund. Indeed, in order to deal effectively with the challenges of uncertainty, information asymmetry and opportunism, investors in venture capital funds are becoming not only more selective, but also tougher in negotiating the terms and conditions of the deals. Predictably, the more active approach of investors will bring about a cultural change in the venture capital industry.¹¹⁶ In fact, we

110 See also Dirk Zetzsche, *The EU Regulation of Venture Capital: Does Law Matter?*, Presentation at the Tilburg Business & Financial Law Seminar, Tilburg, The Netherlands, June 2012.

111 See EVCA Press Release, *Agreement reached on European Venture Capital Funds Regulation without depositary requirement*, 29 June 2012.

112 See Ben Rooney, *European Venture Capital Poised for Rebound*, *The Wall Street Journal*, *TECEurope*, 4 May 2012. See also *supra*, n. 69.

113 See European Commission, ‘Expert group report on removing obstacles to cross-border investments by venture capital funds’ (Brussels; DGEI, 2007).

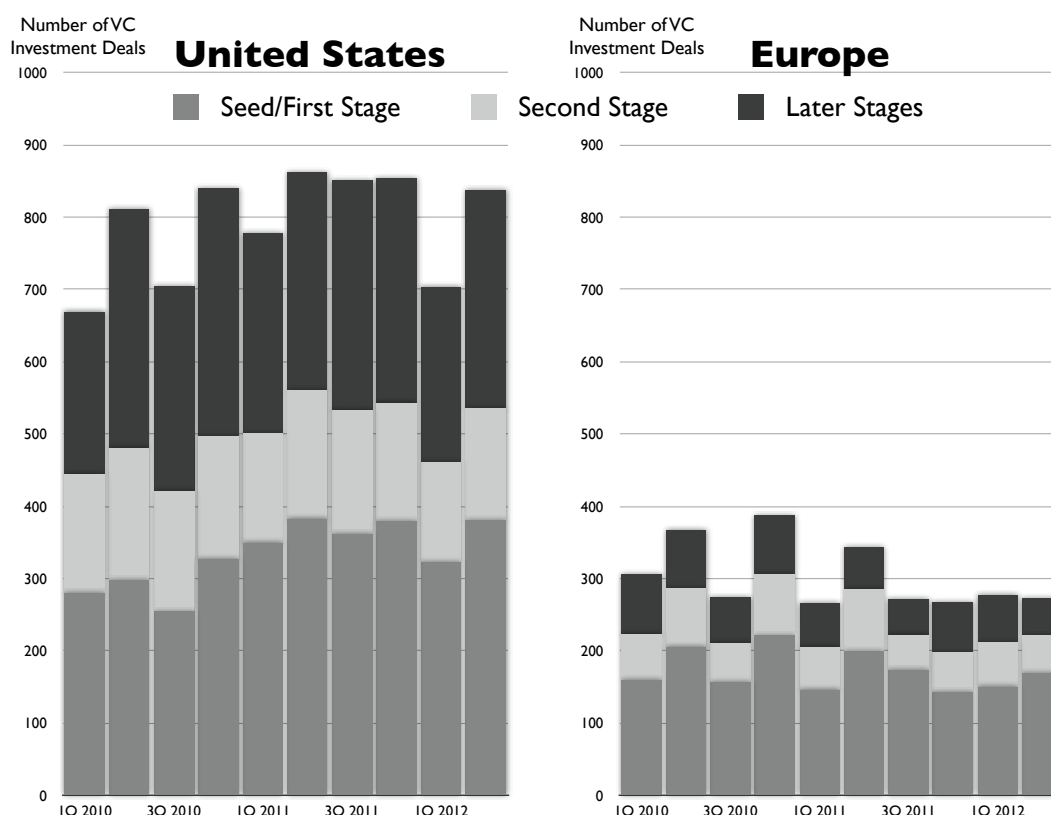
114 Own research with data provided by data provider Preqin – Venture Deals Analyst.

115 Josh Lerner, Yannis Pierrakis, Liam Collins and Albert Bravo Biosca, *Atlantic Drift, Venture capital performance in the UK and the US*, NESTA, Research Report, June 2011.

116 See Janke Dittmer and Erik P.M. Vermeulen, *The New Venture Capital Cycle: From Vicuous to Virtuous*, Working Paper, Forthcoming 2012.

already see a trend towards more collaboration between fund managers and investors. For instance, institutional investors generally demand greater clarity in fund terms. They also increasingly prefer to invest in venture capital funds that are willing to better accommodate their specific concerns, particularly related to compensation arrangements and disclosures.

Figure 6: Deal Flow Allocation in Europe and the United States



Source: Data from Dow Jones VentureSource

Collaborations in the fundraising process are taken a step further if the fund managers decide to select their investors on what researchers have called ability-based and affinity-based characteristics.¹¹⁷ To give one illustrative example, Mr. Chamath Palihapitiya, who started his Social+Capital Partnership firm in 2011, had deliberately chosen not to raise funds from anonymous institutional investors, but instead hand-picked a dozen or so active investors for their specific individual qualities.¹¹⁸ He believes that a venture capital fund that is only backed by passive investors is not sufficiently equipped to fertilize a promising and innovative idea. This explains why Mr. Palihapitiya has recruited patient investors with different abilities and affinities.¹¹⁹ Unlike a traditional venture capital fund, Social+Capital Partnership has as a unique feature that, at the request of the

¹¹⁷ See Paul Gompers, Vladimir Mukharlyamov and Yuhai Xuan, The Cost of Friendship, NBER Working Paper Series, Working Paper 18141, June 2012.

¹¹⁸ See Drake Bennett, The League of Extraordinarily Rich Gentlemen, BusinessWeek, 30 July 2012.

¹¹⁹ See Evelyn M. Rusli, In Flip-Flops and Jeans, An Unconventional Venture Capitalist, The New York Times (DealBook), 6 October 2011.

manager, fund investors are actively involved in the investment process, provide direct advice to start-up companies and assists them directly in the development of new technologies. Through the collaborative process, Mr. Palihapitiya hopes to disrupt the traditional – but often underperforming – venture capital model.

Mr. Palihapitiya's collaborative view leads to two adjacent questions: Could we foresee the emergence and routinization of new disruptive contractual practices in the venture capital industry? And, are there specific types of venture capitalists or investors that could act as a catalyst in the widespread implementation of more collaborative practices in the venture capital industry? Interestingly, the organization and structure of Social+Capital Partnership contains most of the answers. What is also interesting from an evolutionary point of view is that we see converging trends in the venture capital industries in Europe and the United States. Could we foresee the closing of the fundraising and investments gaps that currently separates the venture capital industries in Europe and the United States? Let us look into this in more detail.

3.2 Venture Capital Fund Agreements

3.2.1 Current Developments in Venture Capital Fund Agreements

As we have discussed in Section 2, venture capital funds around the world predominantly employ the limited partnership or an equivalent business form. There are obvious reasons for this, such as tax benefits and the flexibility surrounding its organization, structure and terms. Individuals and institutions that invest in a limited partnership choose to delegate investment and monitoring decisions to the venture capitalists, who act as the general partners. The relationship between the limited partners and general partners is usually characterized as a principal-agent relationship. In order to make this work, legal practice tends to include boilerplate clauses in the limited partnership agreement that are designed to reduce the agency costs by aligning the incentives of the general partners with the interests of the investors (see also Figure 7). The boilerplate arrangements in venture capital limited partnerships can roughly be split in three separate categories (1) fund formation and operation provisions, such as limits on the fund-raising period, the lifespan of the fund, and the required managers' contribution, (2) management fees and carried interest, and (3) the governance structure to ensure that the fund is organized and managed in the most effective manner.

Clearly, the tried-and-tested standard terms and conditions in the limited partnership agreement lower transaction costs and offer contractual transparency necessary to induce investors to make their money available for the investments in start-up companies. Consider again the traditional compensation structure of 2 to 3 percent management fee on committed capital and a 20 percent carried interest – the so-called '2 and 20 rule'. As discussed in Section 2, this rule appears to be a ubiquitous feature of the limited partnership agreement. However, limited partners usually mistakenly believe that the boilerplate '2 and 20' rule ensures a proper alignment of interest and incentives. To

see this, imagine a fund with a committed capital of \$1 billion. The ‘fixed’ management fee will be at least \$20 million every year, independent of the fund’s performance. To be sure, the fixed management fee is reasonable for managers of smaller funds who mainly use the money to cover the fundraising, investment and value-added expenses. But the direct link between the committed capital and the management fee tempts fund managers to create funds far beyond the optimal fund size of between \$100 million and \$500 million. Moreover, it encourages them to focus on ‘short-term’ fundraising rather than selecting – and investing – in ‘long-term’ emerging growth companies. Finally, looking back at the difficulties of fundraising discussed in the previous Section, we can also see how the management fee arrangements encourage the emergence of ‘zombie funds’.¹²⁰ Indeed, a hostile fundraising environment has materialized in the post-financial crisis era. Fund managers find it difficult to attract sufficient capital for their follow-on funds. Since management fees generally continue through the fund’s extended life, the compensation arrangements provide the fund managers with the incentives to keep a near-dead venture capital fund alive by holding on to underperforming portfolio companies.

The continuous use of the dominant boilerplate provisions by venture capitalists, even if they are not ideally suited to investors, could be viewed as a form of ‘pluralistic ignorance’.¹²¹ It may be argued that investors accept the ‘inefficient’ boilerplate provisions not because they believe that the standardized terms and conditions sufficiently align the interests of investors and managers, but merely because they think their peers, including the venture capitalists, prefer to include them in the limited partnership agreement. The often-ineffective ‘2 and 20’ rule may persist for this reason. Yet the financial crisis has arguably led to deviations from the boilerplate provisions.¹²² An example of such a deviation is the scaling down of the management fee after the investment period is over, recognizing the declining workload of the general partners in the later stages of the fund’s life. The scaling down formulas have become gradually ‘investor favourable’, but they still vary widely. Sometimes scaling down is achieved by using a lower management fee percentage after the investment period. In other cases venture capitalists propose to take a percentage of the invested capital – instead of the committed capital – after the investment period. We also see combinations of the two. As a rule of thumb, the average management fee is currently approximately 1.5% of the committed capital over a 10 years period.¹²³ Under the scale down arrangements, the average fee will even be lower if the fund’s life is extended due to the current uncertainties in the financial markets.

Another example is the increasing demand for restricted, European-style profit distribution arrangements, better known as ‘waterfall’ arrangements, in US limited partnership agreements.

120 See Susan Pulliam and Jean Eaglesham, Investor Hazard: ‘Zombie Funds’, *The Wall Street Journal* (Markets), 31 May 2012.

121 See Richard H. Thaler and Cass R. Sunstein, *Nudge, Improving Decisions About Health, Wealth, and Happiness*, Penguin Books, 2009.

122 See *supra*, n. 15.

123 See Brad Feld and Jason Mendelson, *Venture Deals, Be Smarter than Your Lawyer and Venture Capitalist*, John Wiley & Sons, Inc., 2011.

Currently, European funds can be distinguished from their US counterparts in terms of the strict rules regarding the distribution of profits to managers, the possibility to remove the managers or dissolve the fund, the inclusion of key-person provisions, and less severe penalties for defaulting limited partners. Moreover, given the lack of trust and reputation effects, European funds are required to use specific valuation guidelines to reduce the information asymmetries. To give some ideas, an empirical survey among 51 US and 26 European venture capital funds in 2009 shows that managers of 67% of the European funds had to abide by very strict standards regarding the distribution of profits.¹²⁴ The managers were only allowed to share in the profits after the investors had received the preferred return that was stated in the limited partnership agreement. In the United States, this percentage is only 23%. Moreover, fund managers in Europe are held on a tighter leash regarding the valuation of their portfolio companies. Some 69% of the fund managers were required to employ predefined valuation guidelines for investments in start-up companies, compared to 25% in the United States. The focus on investor protection is also evidenced by the inclusion of key-man provisions, which purpose is to avoid the departure of certain fund managers, in 84% of the analyzed European venture capital fund agreements; 65% of the US agreements contained such a provision.

Despite these current differences, the contractual arrangements in Europe and the United States are converging in a number of important ways. This is particularly evident in the growing insistence of US investors on restricted arrangements regarding the time of the distribution of carried interest. It is still common in the United States that a carry is paid out at the occurrence of each exit and before a preferred return is provided to the investors. This may create perverse incentives to the managers to chase early carry distributions by pushing through profitable exits early in the fund's life. Certainly, if at a later stage it transpires that the general partners have received more than their fair share of the profits, investors will be entitled to call upon the clawback provisions under which the managers have to pay back the excess carry distributed earlier. Because clawback provisions are not easily enforced,¹²⁵ however, it is to be expected that investors more and more insist on including European-style preferred return provisions in the agreements rather than engaging in contentious discussions with managers *ex post*.¹²⁶ The convergence between the limited partnership agreements in the United States and Europe is illustrated by the introduction of the 'waterfall' provisions in the Institutional Limited Partners Association (ILPA).¹²⁷

Thus, we generally see changes to the boilerplate provisions when the venture capital market experiences difficulties in attracting investors and raising funds or lacks implicit mechanisms that prevent opportunistic behaviour and misappropriation. What is remarkable still is that although empirical research indicates that investors are in a stronger bargaining position in venture capital deals,

¹²⁴ See *supra*, n. 16. See also Joseph A. McCahery and Erik P.M. Vermeulen, *Venture Capital Beyond the Financial Crisis, How Corporate Venturing Boosts New Entrepreneurial Clusters (and Assists Governments in Their Innovation Efforts)*, *Capital Markets Law Journal*, Vol. 5, 2010.

¹²⁵ See *supra*, n. 94.

¹²⁶ See Private Equity International, *Institutional Investor Sentiment Survey*, July 2012.

¹²⁷ See www.ilpa.org

so far we do not see a clear rejection of the boilerplate provisions. The more stringent terms regarding compensation and distribution of profits, for instance, have ‘only’ masked – not solved – the incentive issues. Surely the ‘scale down’ provisions have become more ‘investor favourable’, but the management fee arrangements still have the potential to create perverse incentives for fund managers. Consider again the emergence of more ‘zombie funds’. If the management fee is linked to the actual invested capital – instead of the committed capital – managers have an incentive to overvalue a fund’s nearly dead portfolio companies.¹²⁸ Also, according to a recent study, it would be a mistake to believe that the common preferred return provisions and subsequent catch-up provisions give adequate incentives to general partners to engage in long-term thinking.¹²⁹ It shows that the common ‘waterfall’ provisions may still entail a trade-off between short-term compensation for the general partners versus long-term capital gains for the investors. The researchers argue that if the general partners only start to share in the profits after the preferred return is met, they have an incentive to pursue quick exit strategies to ascertain early returns on investment. Obviously, the general partners are focused on reaching the catch-up period as quick as possible, while the investors want to see the best – not necessarily the fastest – return on their investment.

3.2.2 Future Developments in Venture Capital Fund Agreements

Thus, the question is whether we can expect to see more dramatic revisions to the limited partnership agreement, rejecting the long-standing contractual practices. In order to answer this question, we have to distinguish among various options that are available to institutional investors (see Figure 7). The first option is to become a limited partner in an expansion or late stage fund. If we look at funds that held their final close in the period 2010 to May 2012, we observe that 18 percent of them focus on later stage/expansion investments.¹³⁰ To be sure, the majority of the funds – 55 percent – adopt a multi-stage approach. But, due to the subdued fundraising environment, some of these more general funds also show a general propensity to finance later stage, lower-risk companies.¹³¹ This trend is particularly visible in the United States (see Figure 6). In the context of later stage investments, where minimizing risk and maximizing financial return prevail, the venture capitalists attempt to gain a good reputation and outstanding track records. This observation corresponds to the ‘survival of the fittest’ finding. Still, the move to later stage investments will not lead to significant changes in limited partnership agreements. Indeed, as we have seen in the previous subsection, we can only observe a gradual shift towards more investor-favourable limited partnership agreements.¹³² The areas in which

128 If the investors contend the valuations, thorny and costly valuation discussions will follow.

129 See James Taylor, Do waterfall provisions lead to conflicts of interest, Private Equity International, 9 August 2012.

130 Data derived from Preqin Special Report: Venture Capital, May 2012.

131 See Pui-Wing Tam and Amir Efrati, Web Start-Ups Get Upper Hand Over Investors, VC Firms Drive Up Valuations, Attach Fewer Strings to Deals, Wall Street Journal, 10 March 2011.

132 See also Preqin Investor Network: Challenges Facing LPs Investing in Private Equity, Private Real Estate and Infrastructure, August 2012.

we have seen some marginal revisions are in the compensation, management fee and waterfall provisions.

The second option for institutional investors is to seek a higher degree of control and flexibility over their capital commitments, thereby becoming more actively involved in the investment choices. For instance, in order to get around the obligation to passively make the capital contributions to a traditional fund when called upon by the general partners, institutional investors may look for fully-customized investment solutions by entering into separate accounts arrangements. These arrangements are different from the organization of traditional funds in that an investor's capital contribution will only be invested in accordance with its specific investment strategies and interests. From the perspective of more 'active' limited partners the benefits are twofold. Firstly, separate account arrangements are flexible in the sense that they are usually tailored to the investors' risk appetite and diversification needs. Secondly, it is obvious that arrangements between a single limited partner and a venture capital firm enable investors to bargain for better terms and conditions, including 'disruptive' and investor-favourable management fees and carried interest provisions. It is only to be expected that institutional investors be more inclined to invest in separate accounts in the future. This is confirmed in an empirical study that shows that, even though only 7 out of 100 surveyed institutional investors have set up a separate account arrangement, 35% of the investors are seriously considering investing through a separate account arrangement in the future.¹³³ Apparently, these arrangements are most popular amongst fund investors with assets under management of up to US\$ 5 billion, making up 79 percent of the 35 investors that reacted positively to the adoption of separate accounts provisions.

Option three is making investment decisions on a deal-by-deal basis. Obviously, investors may decide to invest directly in venture capital opportunities. But the uncertainties and information asymmetries often deter institutional investors from investing directly in high growth companies. Yet, in an attempt to make investments in the best performing companies more lucrative, we see an increase in venture capital deals with institutional investors piggybacking on the due diligences and selection efforts of their fund managers by pursuing a co-investment strategy.¹³⁴ Indeed, recent studies show that co-investments gain in popularity. One of the studies even found that co-investment rights provisions are already a must-have for institutional investors.¹³⁵ Investors' search for greater control over both the investment decisions and the negotiations of the fund terms has also led to alternative fund structures, such as pledge funds.¹³⁶ Pledge funds offer investors the opportunity to make investment decisions on a deal-by-deal basis. To put it simply, a pledge fund is a combination of the

¹³³ See Emma Dineen, *Changing Methods of Accessing Private Equity*, Preqin Private Equity Spotlight, July 2012.

¹³⁴ Co-investments alongside qualified venture capital funds are particularly gaining momentum in Canada. In the US, see also the example of Correlation Ventures, a venture capital firm that uses a co-investment model as well. See <http://correlationvc.com/>.

¹³⁵ See *supra*, n. 133.

¹³⁶ See Jonathan Blake and Liz Judd, *Bespoke Tailoring*, Expert Commentary SJ Berwin, Fund Structures 2012, Private Equity International, April 2012.

best elements of a venture capital fund and a loose network of angel investors.¹³⁷ Similar to a venture capital fund, a pledge fund is typically managed by experienced venture capitalists or business angels, who are responsible for deal flow development, investment selection and portfolio management. The investors, however, have more discretion on whether to accept the fund managers' investment proposals. In order to get access to investment opportunities, the investors must pay an annual fee. Although admitted investors can review potential portfolio companies, they are usually not obliged to participate in the deal. If the managers receive sufficient commitments from the 'member investors', they can prepare and negotiate the deal documents on behalf of the fund – in most cases a separate limited partnership is set up to make the investment in the start-up company. The advantages are clear. Besides the greater control over portfolio acquisitions, the pledge fund alternative also gives investors the possibility to avoid high management fees and carried interest.¹³⁸ The downside is that pledge funds structures usually come with higher transaction costs. Moreover, it should be noted here that the direct involvement of institutional investors in early stage venture capital deals is still limited. They particularly look to gaining exposure to direct investments in the less risky later stage and private equity/buy-out deals.¹³⁹

Given that institutional investors tend to become more 'active' limited partners, the fourth option – investing in a fund of funds – will arguably become less attractive in the future. A fund of funds is an investment vehicle that mainly invests in other funds. In an effort to obtain a higher degree of control and transparency over the fund's portfolio companies and investment decisions, institutional investors are spending more time analyzing venture capital fund agreements and negotiating more favourable terms. A more active approach to portfolio choice and management as well as the belief that management fees should be better aligned with the interests of the investors appear to be good reasons not to invest in fund of funds.¹⁴⁰ Obviously, investing in a fund of funds, which has the simple and easy diversification of investments as one of its main characteristics, is not an attractive option for 'active' institutional investors that want to be exposed to a particular market niche. The complicated and non-transparent fund of funds fee structure makes the fourth option even less appealing. Investors have to take account of the compensation and management fee structures of both the 'fund of funds' and the 'direct' funds that they invest in. The 'double' fund with the 'double' management fee structure usually leads to higher investment costs.

Both of the reasons for ignoring fund of funds – less focus and higher costs – sound valid. The empirical truth, however, is exactly the opposite. Data shows that fund of funds currently witness an

137 See Jonathan Tower, *The Rise of the Pledge Fund*, *Adventure Capitalist*, 19 May 2008.

138 See Gregoire Gille, *Pledge Funds Not a Panacea*, Says SJ Berwin's Sonya Pauls, *unquote.com*, 18 April 2012.

139 See also Prequin Special Report: *Venture Capital*, May 2012. The Report shows that the percentage of investors looking to target venture capital over the next twelve months has decreased significantly during the first half of 2012 (15%) compared to the first half of 2011 (28%). The interest of investors in small- to mid-market buyout funds remained steady (52 percent during the first half of 2011 and 49 percent during the first half of 2012).

140 See *supra*, n. 126.

upsurge in the private equity and venture capital industry.¹⁴¹ The number of funds reaching a final close in 2011 totaled 74, an increase of 35% percent compared to the number of closings in 2009. The capital raised by managers of fund of funds decreased from \$21 billion in 2009 to \$15.4 billion in 2011, most likely due to the financial crisis. Why are institutional investors willing to pay for the higher fee structure of fund of funds? Why do we see a rise in the number of funds of funds closings in the wake of the financial crisis? An explanation for these questions is that participations in funds of funds is a way for institutional investors to reduce the significant transaction costs that must be incurred in selecting, setting up and maintaining the relationship with the general partners of one or more direct funds. Indeed, it is cumbersome and time-consuming for institutional investors to select venture capital funds and fund managers that have the strongest track records – unless, of course, they already invested in a previous fund that was managed by a successful and well-performing venture capital firm before.¹⁴² The costs of performing the due diligence, negotiating the limited partnership agreement, and monitoring the fund managers are often higher than the costs related to the fund of funds structure – again, unless investors already established a relationship with particular fund managers. In order to mitigate the effects of the uncertainties and information asymmetries that abound in the area of venture capital, institutional investors increasingly turn to the experienced and knowledgeable fund of funds managers. Particularly in Europe, the fund of funds strategy offers an attractive alternative in anticipation of the strengthened regulations that will apply to institutional investors in the near future.¹⁴³

3.2.3 Summary and Prospects

In this Section, we have mainly focused on fundraising activities from institutional investors. For reasons explained earlier, however, institutional investors have generally become more conservative and risk-averse. They are increasingly loath to invest in early and mid-stage funds. If institutional investors seek to be involved in venture capital, they more and more invest (directly or indirectly) in later stage companies. If they back early or mid-stage venture capital partnerships, they tend to screen for top-performing fund managers or back funds that they previously invested in. Obviously, these ‘survival of the fittest’ developments – that we see in both Europe and the United States – will not ensure a sustainable venture capital industry in the long run. Luckily, more and more fund managers start to realize that they have to seek other types of investors based on their particular abilities and affinities. Consider again Social+Capital Partnerships. Mr. Palihapitiya views the investors in his fund as ‘active’ partners who, if requested, assist in due diligence activities, provide advice to start-up companies and assist them in the development of the new technology. With the limited partners’ independent and supportive attitude, Mr. Palihapitiya hopes to build relationships that can lead to a

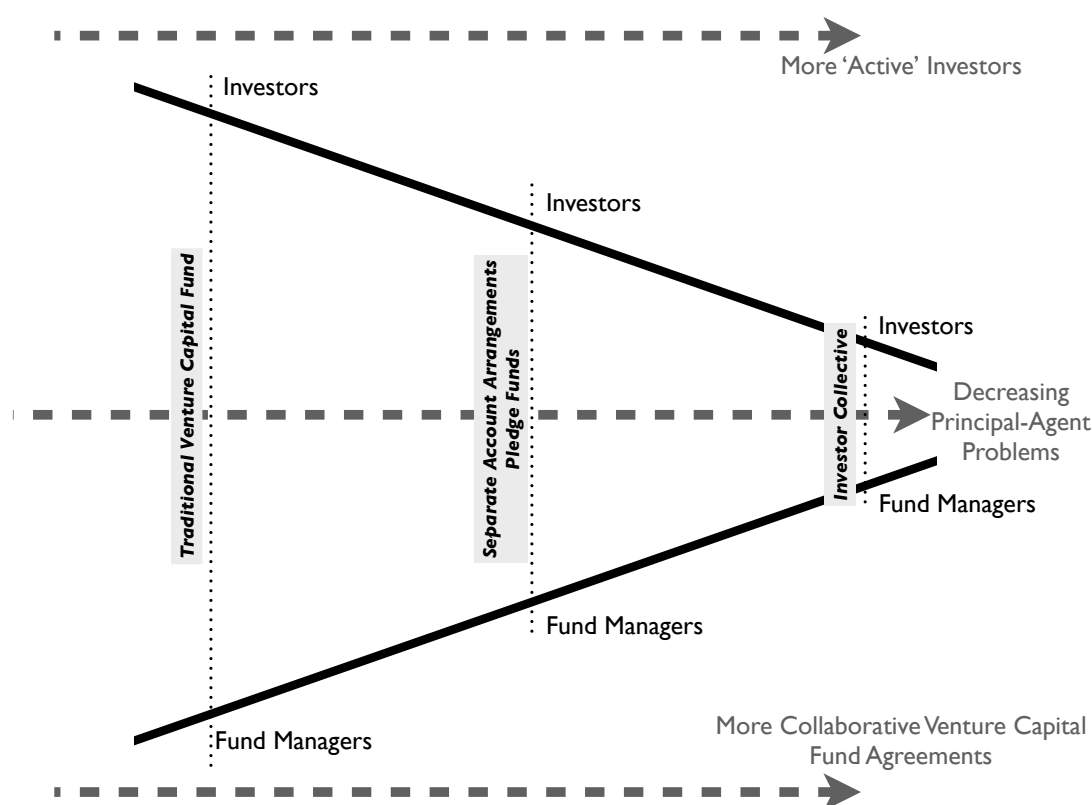
¹⁴¹ Data derived from data provider Preqin.

¹⁴² See Igor Sill, *The Changing Venture Capital Landscape*, Sand Hill, 20 March, 2012.

¹⁴³ See *supra*, n. 75 and 76.

‘joint’ development of new products for new markets, thereby creating value where it did not exist before. If this is indeed a new trend, we can only expect that venture capital fund managers seek investors who cannot only reliably commit capital for the entire duration of a fund, but also add additional value to a fund’s operation and investment policy. What better place to look for such investors than angel investors, other venture capital funds, established multinational corporations and family offices (that represent the interest of the families and their businesses). In the next subsection, we will discuss the ‘new’ sources of active, but patient venture capital providers. We will focus particularly on the involvement of corporations as anchor investors in venture capital funds.

Figure 7: The Evolution of Venture Capital Fund Agreements



3.3 New Capital Sources for Venture Capital Funds

In order to be able to build internal teams that are best positioned to add value to the early and mid-stage start-up companies, Social+Capital Partnerships is organized in an egalitarian rather than a typical ‘general partner – limited partner’ fashion (see also Figure 7). The egalitarian structure manifests itself in the rejection of the typical organization between limited partners and general partners. Particularly, we see a dramatic change in the distribution and compensation arrangements. For instance, instead of the usual 1 percent, Mr. Palihapitiya has contributed a bit more than 20% of the committed capital. Moreover, the general and limited partners share equally in profits and losses. There is no carried interest. What is even more remarkable is that Mr. Palihapitiya is on a fixed salary

arrangement, which is not linked to a percentage of the committed or invested capital. Since the limited partners in Social+Capital Partnerships act as a kind of venture capitalists-on-demand, being more closely involved in investment decisions, the fixed management compensation structure is likely to be more effective compared to the incentive pay regime which we normally see in limited partnership agreements. Indeed, the active and knowledgeable investors in Social+Capital Partnerships are in a better position to effectively and timely monitor Mr. Palihapitiya's management and investment decisions. Unlike the 'passive' institutional investors, they do not only have to rely on the contractual arrangements to help reduce the principal-agent problem.

Given the venture capitalists' focus on institutional investors to make up their limited partner base, it would probably go too far to suggest here that we would see an immediate climate change in the negotiations of venture capital agreements. Yet Mr. Palihapitiya's partnership structure could very well be viewed as the result of the new trends in the global venture capital industry. Indeed, if we take a closer look at its organizational structure, it appears that the Social+Capital Partnerships combines a number of trends that have the potential to disruptively transform the venture capital business model from 'venturing-driven' to 'partnering-driven'. Consider the following facts. The 'on-demand-status' of the investors of Social+Capital has some similarities with the discussed pledge funds. More interestingly and in sharp contrast to traditional venture capital funds, Mr. Palihapitiya has made a significant investment in its own fund. In fact, Social+Capital Partnership operates like a real partnership in which investors carry on a venture capital firm collectively, sharing gains and losses proportionally. Social+Capital Partnership has several specialized investors at its disposal, such as reputed venture capitalists, a private equity investor, a hedge fund manager, and several successful serial entrepreneurs. In this respect, it resembles a super angel fund or a micro/boutique venture capital fund. These funds appeared in the mid-2000s. Moreover, Social+Capital Partnership has also attracted strategic investors, such as Facebook and the corporate venturing unit of the Mayo Clinic. To be sure, the involvement of corporate venture capital organizations in the venture capital cycle is not new. Corporations already introduced venture capital initiatives in the eighties and nineties. But corporate venture capital initiatives are altering their investment strategies from mere financial participations in promising start-ups to more explorative and strategic investment modes, thereby entering into partnership-type relationships with both venture capital firms and emerging growth companies. Before we explain corporations as venture capital fund investors in more detail, we first give some examples of funds in which either the fund manager or other angels and venture capital funds act as 'anchor' investors: (1) micro-venture capital funds and (2) 'joint' venture capital funds.

3.3.1 Fund Managers, Angels and Venture Capital Funds as Anchor Investors

Micro-venture capital funds (or super angel funds) are becoming more and more established in the venture capital industry.¹⁴⁴ In general, these funds are managed by former entrepreneurs who usually contribute a significant amount of capital to their own fund.¹⁴⁵ But there is more, the micro-venture capital funds tend to pursue a ‘partnership strategy’ with their investors.¹⁴⁶ By doing so, they were able to attract other investing interests from friends, other angels, wealthy individuals and family offices that are often looking for highly innovative investment opportunities for their wealth.¹⁴⁷

The collaborative synergy that emerged from these investment teams has attracted considerable interest from university endowments and other institutional investors.¹⁴⁸ Tables 5 and 6, which give an overview of the most notable micro-venture capital funds, show that these funds are currently able to secure capital commitments in the amount of \$20 million to \$100 million, an amount that is rapidly growing. Indeed, investing in the ‘have-been’ entrepreneurs is very appealing. Because they are extremely well connected in their former line of business, they are often better positioned than traditional venture capitalists to pick out winners, but also able to mentor them through the very early start-up phases, increasing the possibility of follow-on investments from ‘traditional’ venture capital funds and corporations.¹⁴⁹ It is often said that micro-venture capital funds seek to make deals that established firms, such as Kleiner Perkins Caufield & Byers and Sequoia Capital, would have made in the old days. Micro-venture capital funds are thus positioned between the traditional angel investors and venture capital funds in terms of the scale of their investment portfolio. They usually provide early stage start-up companies with value-added services and capital contributions in amounts that range from \$25,000 to \$1 million.¹⁵⁰

A good illustration of a ‘joint’ venture capital fund is the partnership between First Green Partners, a new early-stage venture capital firm, and Warburg Pincus LLC, a leading global private equity firm. In the ‘joint venture’, Warburg Pincus is an anchor investor with a capital commitment of \$355 million. Warburg Pincus’ expertise in the energy industry and its network in conventional and unconventional energy is perhaps an even more valuable tool to First Green’s investments in applications of clean and green technologies.¹⁵¹ And there are more examples. Consider the Silicon Valley venture capital firm Redpoint e.ventures, which was jointly created by two other Silicon Valley

144 See Judith Messina, ‘Super angels’ come down to earth, Crain’s new york business.com, 5 September 2012.

145 See Tomio Geron, Angel investors get backers of their own, Wall Street Journal, 22 July 2010.

146 See Tom Kerr, Super Angels Give VCs a Run for Their Money, Venture Hype, 1 September 2010.

147 See Brad Feld and Jason Mendelson, Venture Deals, Be Smarter Than Your Lawyer and Venture Capitalist, John Wiley & Sons, Inc., 2011.

148 See VC ‘Super Angels’: Filling a Funding Gap or Killing ‘The Next Google’?, The Wharton School, 1 September 2010.

149 It is therefore not surprising that reputed, well-established venture capital firms are willing to welcome these ‘have-been’ entrepreneurs as partners. For instance, former founders of LinkedIn, Reid Hoffman and Konstantin Guericke, are currently partners in US Greylock Partners and German EarlyBird, respectively.

150 See Spencer E. Ante and Pui-Wing Tam, Big Tech Investors Want a Piece of the Micro Pie, The Wall Street Journal (Technology), 27 January 2012.

151 See Global Corporate Venturing, Warburg Pincus backs new VC, January 2012.

pioneers Redpoint Ventures and e.ventures in July 2012.¹⁵² The fund, mainly backed by the joint venturers and their investors, had raised \$130 million for investments in early-stage internet start-ups in Brazil. Similar to the micro-venture capital funds, it appears to be relatively easy for these joint initiatives to attract the interest of other investors. For instance, Germany-based mail order company Otto Group, which is also a long-time investor in e.ventures, has committed \$20 million to Redpoint e.ventures. The US networking equipment company Cisco is another investor with a commitment of \$15 million.¹⁵³ This brings us to the other ‘alternative’ source of capital: Corporations.

Table 5: Micro Venture Capital Funds in the United States

The United States					
Name	Experience	Firm Name	Latest Fund Size (\$M)	Deal Experience	Notable Investments
Peter Thiel	Paypal (co-founder), Facebook (first outside investor)	Founders Fund	Founders Fund IV (2012) (\$625) Founders Fund III (2010) (\$250)	65	Facebook, Spotify, SpaceX, Yammer
Ron Conway	PTS, Altos Computers	SV Angel	SV Angel IV (\$40)	176	Google, Paypal, Facebook
Jeff Clavier	Reuters Executive	SoftTech VC	SoftTech VC III (2011) (\$55)	59	Mint, Userplane, Kaboodle
Michael Dearing	eBay, Stanford Professor	Harrison Metal	Unspecified	33	Aardvark, admob, DocVerse
Dave McClure	Paypal	500 Startups	500 Startups I (2011) (\$29)	187	SlideShare, Mint
Aydin Senkut	Google	Felicis Ventures	Felicis Ventures III (2012) (\$70.50) Felicis Ventures II (2010) (\$40)	68	Mint, Tapulous, Disqus
Mike Maples	Motive, Inc.	Floodgate	Floodgate Fund IV (2012) (\$75) Floodgate Fund III (2010) (\$73.50)	77	Twitter, Digg
Bill Trenchard (and others)	Callcast	Founder Collective	Founder Collective II (2012) (\$70)	91	Minyanville Media
Chris DeVore	Judy’s Book	Founders Co-Op	Founders Co-Op II (2012) (\$8)	23	
Roger Ehrenberg	Kinetic Trading Strategies	IA Ventures	IA Venture Strategies Fund II (2012) (\$105) IA Venture Strategies Fund I (2010) (\$50)	40	Recorded Future
Manu Kumar	SneakerLabs, Inc.	K9 Ventures	K9 Ventures II (2012) (\$40)	14	CrowdFlower

¹⁵² See Sarah McBride, Redpoint e.ventures raises \$130 million fund for Brazil, 23 July 2012; Vinod Sreeharsha, Venture Capital Firm Makes Long-Term Bet on Brazil, The New York Times (DealBook), 23 July 2012; Tomio Geron, Redpoint E.Ventures Raises \$130 Million Brazil VC Fund, 23 July 2012; Richard Walters, US fund to back Brazil tech start-ups, The Financial Times, 23 July 2012.

¹⁵³ See Toby Lewis, Redpoint e.Ventures raises \$130m, Global Corporate Venturing, 25 July 2012.

			K9 Ventures (2010) (\$6.3)		
Kenneth Lerer	AOL, Huffington Post	Lerer Ventures	Lerer Ventures II (2011) (\$25) Lerer Media Ventures (2009) (\$8.5)	96	GDGT
Chris Sacca	Google	Lowercase Capital	Lowercase Venture Fund I (2010) (\$8.5)	30	Twitter
Joshua Kushner	UniThrive, (son of real estate magnate Charles Kushner)	Thrive Capital	Thrive Capital Partners III (2012) (\$150) Thrive Capital Partners II (2011) (\$40) Thrive Capital Partners I (2009) (\$10)	24	Hot Potato

Source: Data from Business Insider – Who Are The Super Angels? A Comprehensive Guide, 4 October 2010, The 25 tech angels, 11 good angels, and 18 geeks everyone wants to fly with, San Francisco Magazine, December 2010, Preqin – Venture Deals Analyst, Websites of the respective funds

Table 6: Micro Venture Capital Funds in Europe

Europe				
Name Experience	Firm Name	Latest Fund Size	Deal Experience	Country
Robin Klein (Innovations) & Saul Klein (Lovefilm Int., Skype)	The Accelerator Group (TAG)	Unspecified	42 (in 2010)	United Kingdom
Julie Meyer (First Tuesday)	ACE (Ariadne Capital Entrepreneurs Fund)	\$32 million	Unspecified	United Kingdom
Niklas Zennström (Skype, Kazaa)	Atomico	Atomico Ventures II - \$122 million	41	United Kingdom
Rogan Angelini-Hurlll (Citi Pan European Media Research, Salomon Brothers) & Sean Seton-Rogers (Balderton Capital, Commonwealth Capital Ventures)	PROfounders Capital	\$42 million	10	United Kingdom
Stefan Glaenger (Last.fm), Eileen Burbidge (Ambient Sound Investments) & Robert Dighero (AOL)	Passion Capital	\$60 million	12	United Kingdom
Jos White & Ben White (Star, Messagelabs)	Notion Capital	Notion Capital 2 (2010) - \$112 million Notion Capital - \$40 million	13	United Kingdom
Xavier Neil (ISP Iliad) & Jérémie Berrebi (Net2One)	Kima Ventures	\$15 million	27	France
Pierre Kosciusko-Morizet (PriceMinister), Geoffroy Roux de Bezieux (Virgin Mobile), Stéphane Treppoz (Sarenza) & Ouriel Ohayon (ex TechCrunch.fr)	ISAI	ISAI Fund I - \$45 million	9	France
Marc Simoncini (iFrance and Meetic)	Jaina Capital	Unspecified	11	France
Alexander, Marc & Oliver Samwer (Alando, Jamba)	European Founders Fund	Unspecified	16	Germany
Lars Hinrichs (XING)	HackFwd	Unspecified	7	Germany

Source: Data from Stuart Derrick, 14 Super Angel investment funds operating in the UK revealed, Growing Business, Preqin – Venture Deals Analyst, Websites of the respective funds

3.3.2 Corporate Investors

The involvement of corporations in the venture capital cycle is not new. Corporations already introduced venture capital initiatives in the eighties and nineties.¹⁵⁴ Yet, Figure 8, which contains information about the number of deals with corporate involvement in the United States from 1995 to 2012, shows that corporate initiatives gained momentum at the turn of the century. This is not surprising given the excessive returns in the venture capital industry at that time. Multinational corporations, through their corporate venture capital divisions and subsidiaries, mostly made co-investments in portfolio companies of renowned venture capital funds by entering into syndication arrangements with these funds.¹⁵⁵ This strategy obviously reduced the risks involved in being engaged in venture capital financing. At the same time, corporate venture capital organizations further increased the probability of a successful and profitable investment by focusing on later, and less risky, rounds of investments.

These corporate initiatives had a strong exploitative focus on generating financial returns through sharing in the profits of successful exits. This resulted in corporate involvement reaching its highest level in 2000. That is, 24.9% of the total venture capital deals in the United States were supported by corporate venture capital organizations. Yet, the corporations' venture capital pursuits quickly started to show mixed results. Obviously, after the dot.com bubble burst at the beginning of the millennium, the piggyback approach did not provide the steady and coveted returns to any investor in the industry, including corporate investors. But in the post dot.com era, we already see a change in the scope of corporate initiatives towards seed and early stage investments.¹⁵⁶ Increasingly, multinational corporations endeavour to get more creative in their efforts to attract and integrate outside innovations. In fact, there is a keen awareness among corporations of the need for investing in high growth start-up companies that, in turn, could spur the corporation's own innovation and lead to excessive growth after the recent financial crisis. To achieve this goal, corporations set up incubator programmes and processes for the purpose of building ventures internally.¹⁵⁷ In addition, corporations 'reinvented' their corporate venture capital programmes. These programmes gained particular momentum in the biotech, computer, energy and telecom sectors (see Figure 9). We can distinguish several options that corporations often employ simultaneously in their open innovation efforts. Corporations could, for example, make direct investments in other, mostly entrepreneurial or high-growth, companies. But they could also follow a more indirect investment approach by setting up a venture capital fund or acquiring a limited partnership interest in an already existing – and independent – venture capital fund. It is here that corporate venture capital organizations have altered

¹⁵⁴ See *supra* n. 102.

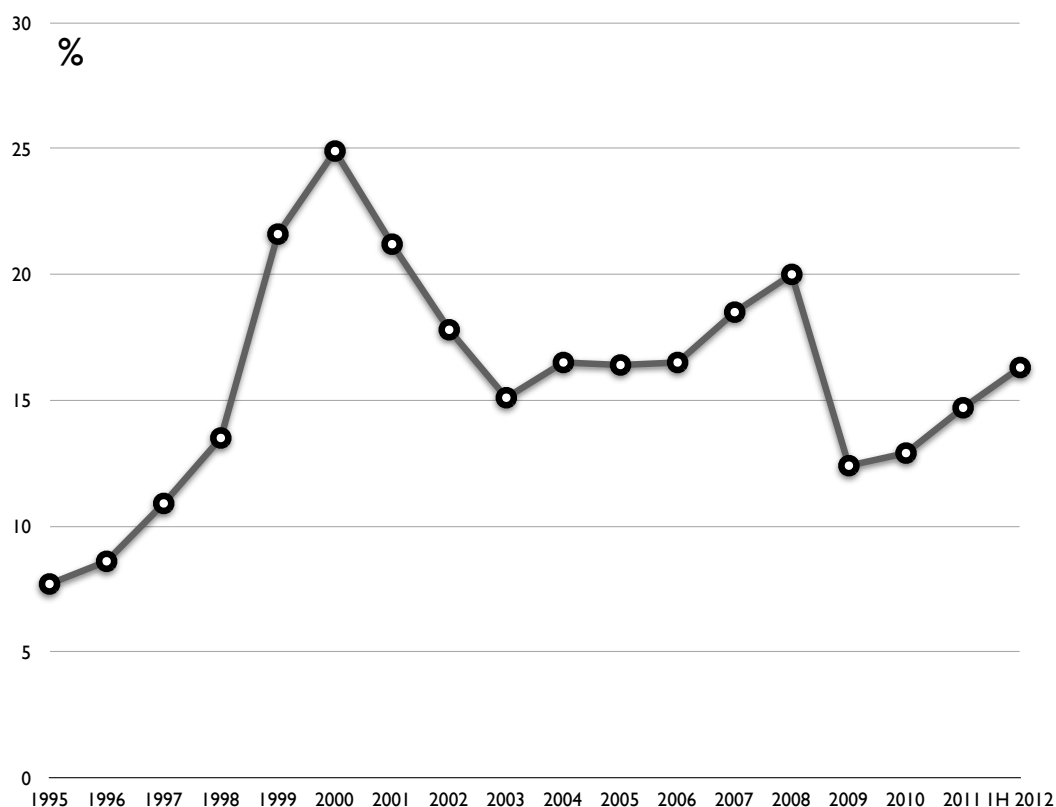
¹⁵⁵ See *supra* n. 5.

¹⁵⁶ See *supra* n. 102.

¹⁵⁷ See Georges Haour, *Resolving The Innovation Paradox, Enhancing Growth in technology Companies*, Palgrave Macmillan, 2004.

their investment strategies from mere financial participations in an innovative start-up company to more explorative and strategic investment modes fitting into their open innovation models.

Figure 8: Corporate Venture Capital Involvement in the United States

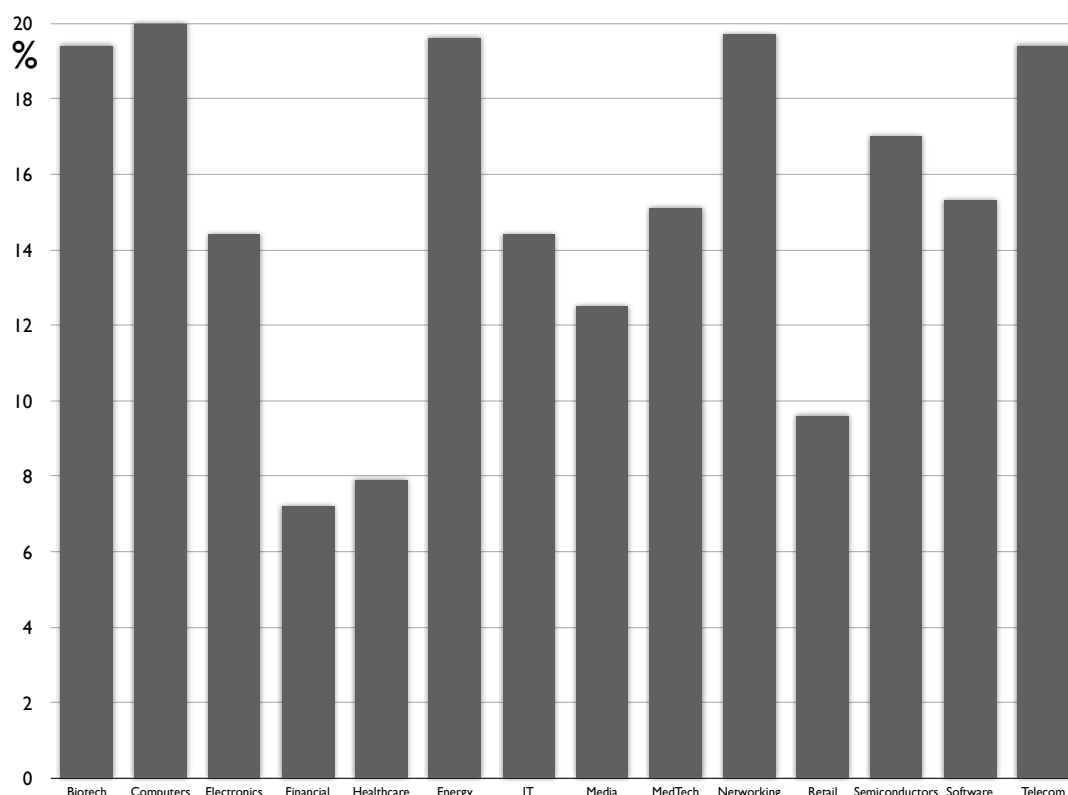


Source: Data Derived from PricewaterhouseCoopers/National Venture Capital Association MoneyTree™ Report/Thomson Reuters

In this light, what is the effect of the changed behaviour of corporations on the venture capital cycle? In our view, the impact of corporations on the venture capital cycle has moved from trivial to profound. In the 1990s, corporations opted for a piggybacking approach. Currently, they play a more dominant role in the venture capital industry by profiling themselves in the market as an attractive investor in venture capital funds. They are reliable in the sense that they are able to contribute their committed capital investments. Moreover, corporations can actively contribute to the reputation of a venture capital fund. In fact, corporate investors optimally facilitate the development of fruitful and lasting collaborations, signaling a quality fund in which other investors, such as family offices, have ample incentives to commit to the funds' strategy and investment decisions. But there is more to attracting corporate investors than their capital contributions and reputation. At the request of the venture capital fund managers, corporations could participate in the due diligence processes of potential investment targets, offer technical and marketing advice to portfolio companies and assist them in the development of the new technologies. Clearly, they could increase the exit opportunities

for venture capitalists, by acting as a potential buyer in an eventual trade sale of a portfolio company that proves to be strategically interesting. Finally, working closely with corporations could create real investment options to the corporation's spin-out or spin-off companies.

Figure 9: Corporate Venture Capital Involvement in the United States per Sector (2011 – 1H 2012)



Source: Data Derived from PricewaterhouseCoopers/National Venture Capital Association MoneyTree™ Report/Thomson Reuters

As is depicted in Figure 9, the relationship between corporate investors and venture capital fund managers also offers a wide array of advantages to the corporations. For instance, setting up a partnership with venture capitalists provides the corporations with a window to the market, helping them to find the ‘next big thing’ in other companies/markets. Moreover, the partnering arrangements are often designed to accelerate a corporation's innovation cycle or to assist in its efforts to expand its technological position to emerging markets. In previous work, one of the authors already gave examples of the possible relationships between venture capital fund managers and corporate investors.¹⁵⁸ Table 7 contains an overview of deals that were concluded in the first half of 2012.

If we see a more strategic involvement of corporations in venture capital funds, the question is what the impact of this will be on venture capital fund agreements. Contrary to a ‘traditional’ venture capital fund agreement, which, as we have seen, mainly sets out conditions for investing, capital

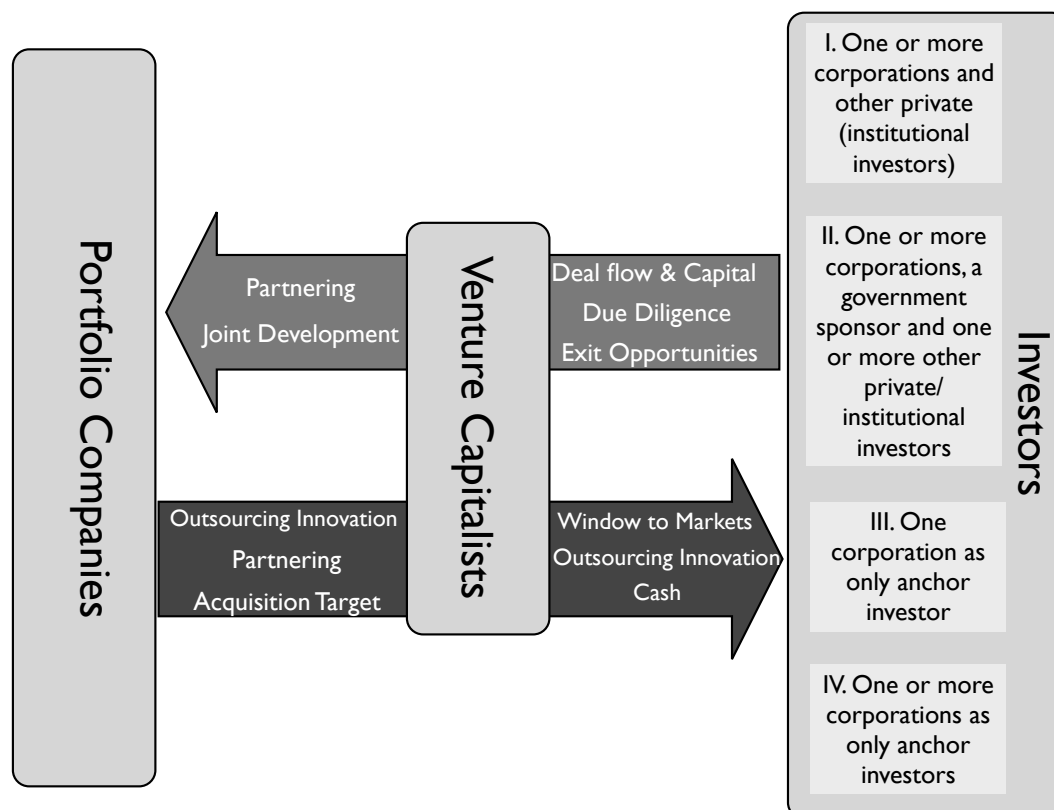
¹⁵⁸ See *supra*, n. 102.

contributions, and compensation and distribution requirements, an agreement with a corporate anchor investor must govern three relationships: (1) the relationship between the venture capitalist and the corporation, as a strategic investor, (2) the relationship between the venture capitalist and the other financial investors, and (3) the relationship between the strategic and financial investors in the venture capital fund. We predict that a positive correlation exists between the demand and use of contractual control restrictions and the propensity of the venture capitalist (and one or more of the strategic investors) to behave opportunistically. Hence, when the venture capitalist raises funds from a strategic anchor investor, the traditional financial investors will bargain for more restrictions and covenants relating to the management of the fund, conflict of interests, and restrictions on the type of investments the fund can make. The restrictive nature of covenants, which must make sure that all investors are treated equally, will come as a ‘natural’ reaction to the uncertainty, information asymmetry and agency costs resulting from the strategic investor’s participation. Still, the use of restrictive covenants can entail inefficiencies and the erosion of value from the partnership, as they restrict the venture capitalists’ ability to benefit from the knowledge, resources and investment opportunities of the strategic corporate investor. It will therefore be common practice that corporations, in conjunction with the venture capitalist, endeavour to obtain more favourable terms than other investors with respect to management fees, deal flows, portfolio selection and monitoring, investment decisions, and co-investment rights. These more favourable terms – that deviate from the underlying limited partnership agreement – are set out in side letters or side agreements. The reputation of both the venture capitalists and the corporation – as a strategic investor – will, of course, affect the other investors’ willingness to accept the side letters for one of their co-investors in the fund.

But even if institutional investors, family offices and other investors have difficulties in accepting the more-favourable deal terms for the strategic corporate investor, the venture capitalists and corporations are still left with three options. The first of these options is for the corporate investor to take a position as sponsor and only anchor investor in a venture capital fund. The second option is to find government sponsorship. When incentives are ill-aligned – as could be the case if a strategic anchor investor enters the scene – it is arguably appropriate for venture capitalists to have governments making fund investments in an attempt to restore the balance of interests among the other strategic and financial investors. Government investments pursue two main goals: (1) they signal the trustworthiness of venture capital initiatives, and (2) their more long-term and patient investment strategy facilitates the development of fruitful and lasting ‘partnerships’ among the strategic corporate investors and other private investors. As the High-Tech Gründerfonds shows, collaborations between governments and large corporations are able to attract a large number of portfolio companies. Moreover, it could be argued that corporations show an increasing interest in public-private partnerships. For instance, the High-Tech Gründerfonds was able to attract a significant number of corporate investors in their first fund that started to make investments in 2005. Corporate investors in Fund I include BASF, Robert Bosch, Daimler, Siemens, Deutsche Telekom, and Carl Zeiss. Fund II,

which commenced investing on 27 October 2011, was able to attract even more corporate interest with commitments from ALTANA, BASF, B. Braun, Robert Bosch, CEWE Color, Daimler, Deutsche Post DHL, Deutsche Telekom, Evonik, Qiagen, RWE Innogy, SAP, Tengermann, and Carl Zeiss.¹⁵⁹

Figure 10: Corporate Investments in Venture Capital Funds



The third option is that the venture capitalist will set up a partnership with two or more corporate investors that are willing to join forces in an investment fund that targets high-potential growth companies and/or other innovative projects. Table 7 already shows several examples. In March 2012, France Telecom Orange and Publicis Groupe decided to work together with Iris Capital in three funds with a different scope: (1) OP Ventures Growth with a focus on established companies in France and Europe, (2) OP Ventures Global with a restricted scope on start-up companies outside Europe, and (3) OP Ventures Early Stage that intends to provide seed and early-stage capital to start-up companies in Europe. Another example is the partnership between Index Ventures and two competing pharmaceutical companies, GlaxoSmithKline and Johnson & Johnson. The €150 million fund mainly invests in single assets that have the potential to become leading products in the future, the so-called asset-centric investment model. The corporate investors provide advice to Index Ventures by appointing their representatives on a scientific advisory committee. In order to avoid potential

¹⁵⁹ See www.en.high-tech-gruenderfonds.de.

conflicts of interest, however, the two multinationals have not obtained any preferential rights (of first refusal) to promising drugs that could emerge from this partnership. If they are interested in acquiring an ‘asset’, they will have to engage in an open competitive bidding process.¹⁶⁰ Similar to Mr. Palihapitiya’s fund, Index Ventures hopes through a supportive, but at the same time independent attitude of its corporate investors to develop a partnership that can lead to a joint development of new drugs and medicines. It follows from these and our previous examples that venture capital fund managers have four different strategies when structuring a future venture capital fund with corporate venture capital organizations (see Figure 10). Of course, it is important to recognize that they can use any combination of the above-referred strategies when setting up a new fund, and that there may be additional strategies not mentioned in this paper that motivate the organization and structure of venture capital funds.

Table 7: Corporate Venture Capital Investments in Venture Capital Funds (First Half 2012)

Name Corporate Investor	Name VC Fund Manager	Name VC Fund	Amount of Investment	Fund's Total (Targeted) Committed Capital	Fund's Scope - Sector	Fund's Scope - Geography
Softbank China Venture Capital (Softbank)	Southern Cross Venture Partners	Southern Cross Renewable Energy Fund	\$100 mln	\$200 mln	Renewable Energies	Australia
Warrants Capital (Silver Ridge) and others	Huatai Financial Holdings (Hong Kong)	Huatai Von Malaysia Fund	\$5 mln	\$500 mln	Commodities & Natural Resources	Asia
Cisco	Riyada Enterprise Development (Abraaj Group)	Lebanon Growth Capital Fund	\$7 mln	\$30 mln	Mixed	Lebanon
Edenred	Partech International	Partech International VI	\$20 mln	\$129.5 mln	E-commerce, digital media & infrastructure technology	Europe and Silicon Valley (US)
Bertelsmann AG	University Ventures	University Ventures Fund	\$51.8 mln	\$100 mln	Higher Education	Europe and US
Point B	Correlation Ventures	Correlation Ventures	Unspecified	\$165 mln	Mixed	US
Mahindra Satyam	SBI Holdings	Unspecified	\$25 mln	\$50 mln	ICT	Global
KDDI	Global Brain	KDDI Open Innovation Fund	\$65 mln	\$65 mln	IT	Japan, Global
France Télécom-Orange, Publicis Groupe	Iris Capital Management	OP Ventures Growth, OP Ventures Global and OP Ventures Early Stage	\$194.5 mln (in aggregate)	\$389 mln	IT, ICT, Digital Media	France and Europe (OP Ventures Growth and Early Stage); Global (OP Ventures Global)
Overseas Private Investment Corp. - OPIC (US Government)	TPG	TPG Alternative & Renewable Technologies Partners	\$125 mln	\$500 mln	Clean-tech	Global (focus on Latin America and Southeast Asia)

¹⁶⁰ See Andrew Jack, GSK and J&J launch €150m fund with Index, Financial Times, 21 March 2012. See also Kristen Hallam, Glaxo Joins J&J in \$200 Million Fund With Index Ventures, BloombergBusinessweek, 21 March 2012.

RIM, Corus Entertainment, Thomson Reuters	Relay Ventures	BlackBerry Partners Fund II	Unspecified	\$150 mln	Mobile Computing	North America (US, Canada)
Johnson & Johnson, GlaxoSmithKline	Index Ventures	Index Life VI	\$100 mln (in aggregate)	\$200 mln	Healthcare	Europe and US
Johnson Controls	Nth Power	Unspecified	Unspecified	\$200 mln	Unspecified	Unspecified
Lenovo	Vertex Venture Capital	Vertex IV Fund	Unspecified	\$200 mln	Broadband communications, digital media and IT	Israel
Evonik Industries	High-Tech Gründerfonds	High-Tech Gründerfonds II	\$3 mln	\$376.8 mln	Mixed	Germany
Goldman Sachs	Core Innovation Capital	Core Innovation Capital I, L.P.	Unspecified	\$45 mln	Financial Services	US
Merck	Lumira Capital	Merck Lumira Biosciences Fund (Quebec), L.P.	\$35 mln	\$50 mln	Life Sciences	Québec, Canada
Groupe Arnault	L Capital Management	L Capital 3 FCPR	Unspecified	\$535 mln	Life Style and Retail	Europe
Essent, Delta	Chrysalix SET	SET Fund II C.V.	\$13 mln (in aggregate)	\$130 mln	Sustainable Energy Technologies	Europe
Merck Research Ventures Fund (Merck)	Flagship Ventures	Flagship Ventures Fund IV L.P.	Unspecified	\$270 mln	Life Sciences	US
RIM and others	Communitech	HYPERDRIVE	\$30 mln	\$30 mln	Incubator	Kitchener-Waterloo area, Canada
BP Ventures, Indian Government	INFUSE Capital	INFUSE Capital Fund	\$9 mln	\$25 mln	Clean-tech	India
Shui On Group	InnoSpring	InnoSpring Seed Fund	Unspecified	Unspecified	Incubator	US and China
Cathay Financial Group, CID and others	appWorks Ventures	appWorks Fund I	Unspecified	\$10.2 mln	App Design	Taiwan
BBVA	500 Startups	500 Startups Seed Fund	Unspecified	Unspecified	Accelerator	Silicon Valley, US
Asahi Glass Company, Mitsubishi Chemicals, JSR Corporation and others	Pangaea Ventures	Pangaea Ventures Fund III, L.P.	\$50 mln	\$100 mln	Advanced Materials	North America, Europe and Russia
BASF Venture Capital (BASF)	Tsing Capital Venture Capital Management Co. Ltd.	China Environment Fund (CEF) IV, L.P.	\$5 mln	\$350 mln	Clean-tech	China
Eli Lilly	BioCrossroads	Indiana Seed Fund II	Unspecified	\$8.25 mln	Life Sciences	Indiana, US
American Electric Power	Braemar Energy Ventures	Braemar Energy Ventures III, L.P.	Unspecified	\$300 mln	Clean-tech	Unspecified
Eli Lilly	TVM	TVM Life Science Ventures VII	\$40 mln	\$150 mln	Life Sciences	Québec, Canada
SBI Holdings, FMO (Dutch Development Agency)	SBI Ven Capital	SBI-FMO Emerging Asian Financial Services Fund	\$51 mln (in aggregate)	\$80 mln	Financial Services	Asia

Source: Data from GlobalCorporateVenturing

Conclusion

In this paper, we have distinguished between two types of regulatory interventions: ‘venture capital exemptions’ and ‘venture capital regulations’. Policymakers and regulators have included ‘venture capital exemptions’ in the AIFMD in Europe and the Dodd-Frank Act in the United States. These exemptions make sense since venture capital funds do not threaten the stability and continuity of the financial system. As we have seen, there is little or no debt or usage of leverage involved in the venture capital industry. What is even more important is that the venture capital industry is relatively small.

Venture capital associations and fund managers in the United States have celebrated the exemptions to the Dodd-Frank. To be sure, despite the fact that the exemptions can be relatively broadly interpreted, some fund managers may find it difficult to qualify as venture capitalists. However, it is widely accepted that the majority of venture capitalists will be able to avoid the costly and cumbersome registration requirements. In Europe, on the other hand, the AIFMD exemptions would have led to a conundrum if policymakers were not considering the introduction of the Regulation on European Venture Capital Funds. Relatively few venture capital funds operate in Europe. The result is that, compared to the United States, less capital is available for fewer rounds of financing. In this context, there is certainly something to a simple registration procedure and the possibility to obtain an EU-passport. As discussed, without the passport, raising and structuring venture capital funds can be quite a regulatory ordeal. The fact that compliance with different rules and regulations in different markets – applicable to the marketing and placement activities in the pre-fundraising, fundraising and post-fundraising phases – significantly increases the transaction costs and explains fund managers’ tendency to limit their fundraising and investment activities to domestic, and sometimes even local investors and start-up companies. A single, simplified and straightforward set of rules for registering the fund and obtaining a passport creates more transparency at EU-level, which is clearly a prerequisite for the development of a deep and robust European fundraising market.

However, venture capitalists and policymakers should not fall prey to what we called ‘optimism bias’. The fundraising landscape has evolved and changed significantly in the post-financial crisis era, leading to a ‘new’ venture capital cycle with ‘new’ types of investors and ‘new’ opportunities. Innovative venture capitalists should take these new trends and developments into account when deciding on how best to structure future venture capital funds (and their underlying partnership agreements). We have discussed four strategies that may be deployed by venture capitalists. The first strategy relates to the ‘survival of the fittest’ trend. It appears that the best performing venture capitalists are still able to attract sufficient interest from institutional investors for their funds. They may only have to slightly tweak the traditional venture capital fund agreement so as to offer more protection to their potential investors. A second strategy, involving the introduction of ‘innovative’ contractual provisions, aims to target more active institutional investors. By offering

customized separate accounts arrangements and deal-by-deal investment opportunities, fund managers increasingly attempt to attract these investors. The third strategy is moved by the idea that strategic – often corporate – investors will be able to improve and accelerate the selection, investment and exit processes. The success of this strategy mainly depends on the reputation and credibility of both the fund managers and the corporate investors in the venture capital industry. Finally, venture capitalists can take a real partnership-type approach by setting up a new fund in which investors are selected on the basis of particular abilities and affinities – and the venture capitalists contribute a significant amount to the fund themselves. The fundraising successes of micro-venture capital funds and joint venture capital funds provide illustrations of this partnering strategy. If venture capitalists are willing to adopt new fundraising strategies – and fortunately we see this already happening – they will continue to play a pivotal role in fostering innovation and entrepreneurship across Europe, the United States and globally.