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The Impact of Regulatory Initiatives on Liquidity for Venture-Backed Companies

Steven E. Bochner

Transcript from Speech Given at Dodd-Frank Symposium, March 11, 2011

Thanks, Professor Bartlett. It’s great to be here sharing the podium with you, as well as my longtime colleague and friend Eric Finseth. It is also an honor to share the podium with Mary Dent of Silicon Valley Bank.

So, the title of this symposium is “Financial Regulatory Reform: Dodd-Frank and Beyond.” Eric and Mary are going to cover Dodd-Frank itself, so I decided to focus my remarks on the “beyond” aspects of our talk. Specifically, I’d like to address what’s happened to the liquidity environment for venture capital-backed companies over the last several years, and the ramifications of those changes.

I would submit that liquidity is the catalyst that drives much of the Silicon Valley capital-formation ecosystem. By liquidity, I mean exits—mergers and IPOs, principally. I’d also like to briefly cover the role regulatory reform has played in the liquidity environment, as well as the market reaction to these developments. In addition, I’ll give you a few thoughts on a topic Mary will address—innovation policy—as possible changes in regulation might be able to alleviate some of the issues that have impacted liquidity for venture-backed companies.

Let me start off with slides containing data from VentureOne, a DowJones affiliate. My first slide shows the impact of venture spending on this region. An impressive percentage of venture capital dollars are spent in Northern California. The data shows Silicon Valley companies generally capture about a third of all venture capital spending that occurs in this country. Venture-capital-backed companies also represent a large percentage of GDP (around 21% in the last data I saw from the NVCA) and are responsible for significant job creation.

This next slide shows that mergers and acquisitions still dominate the liquidity environment, while IPOs have declined precipitously over the decade in both real numbers and as a percentage of liquidity events. There’s been some resurgence in IPOs recently, but the companies look a lot different than IPO candidates have in the past, as I’ll describe in a moment. This data illustrates that for those venture-backed companies fortunate enough to achieve a liquidity event for their shareholders, most are done today via mergers rather than initial public offerings. I think this is important to understand, particularly given the
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unemployment issues that plague our country. IPOs are a large creator of job growth, whereas mergers actually can be job-reduction events, at least in the short term, as buyers seek to extract merger synergies through cost-reduction measures.

This final slide shows the length of the time to IPO for venture-backed companies stretching to eight years plus. One of the many ramifications of this lengthening is the additional private financing requirements imposed on companies. Those funding requirements generally fall on the venture capital community through late-stage growth investments and, to a lesser extent, bank borrowings and other types of capital raising.

So, let me now talk about what I think is the punch line to this data: the fact that private companies are growing ever larger and more mature. They require more financial sophistication and infrastructure than any time in the past in order to contemplate an initial public offering. The other interesting thing—and this is important for venture capital funds—is that the time it takes to grow a company to the point where it actually can consider an IPO sometimes exceeds venture-fund life cycles. In other words, if you invest in a venture capital fund, at some point you want to get a return, and many of these funds have life cycles of five to seven years. If it takes eight or more years to actually get a company to the point where you can achieve a successful liquidity event like an IPO, it creates a business-model problem for the venture capital industry. I think that’s exactly what you’ve seen play out over the last decade in terms of a reduction in the number of venture capital funds, lower returns, and the like.

Now, let me briefly mention the impact of regulatory reform on liquidity for smaller companies. I think some of the lengthening of the time to IPO has to be laid at the doorstep of increased regulation. We saw the lengthening occur partially as a result of Sarbanes-Oxley, which accelerated the federalization of corporate governance—that is, Congress legislating in areas of corporate law and governance that was traditionally the province of state law, something I learned about at Berkeley from people like Professor Buxbaum. Examples of this in SOX include things like independence standards for audit committees and loan prohibitions. I think that both of my co-panelists make the point that Dodd-Frank continues this trend, although there’s nothing like 404 (the SOX internal control reports) in Dodd-Frank, something that’s a huge problem in terms of the cost for companies in America. I think Dodd-Frank can more accurately be considered incrementalism in regulation, at least for most companies, as it seeks to implement things like compensation committee independence standards, whistleblower provisions, claw-back provisions, say-on-pay, and the like. Certainly, those all will have an impact, but I don’t think that they will have the dramatic effect that Sarbanes-Oxley initially had on the
costs of going public and maintaining a public company in a major market in the United States.

Next, I’d like to focus on the ramifications of this lengthening of time to liquidity, and the creation of a gap in our capital market structure. This gap can be characterized, as I’ve noted earlier, by the increase in the maturity that’s required to be a public company, the market capitalization required to go public, and the size and scale required to support the accounting, financial, and reporting infrastructure of a public company. I think nothing illustrates this gap better than the new businesses cropping up to exploit it, as we’ve seen play out in the press recently with new markets like SecondMarket and SharePost developing to take advantage of the illiquidity problem caused by the lengthening of the time to IPO and investors not wanting to wait the eight plus years. As a consequence, these businesses have emerged to create a market and provide some liquidity for private company shareholders.

These new marketplaces for private shares have created stress from a regulatory point of view because some of the provisions under the ‘33 and ‘34 Acts were constructed in an environment where you didn’t have companies of this size requiring the kind of capital required today—nor the number of shareholders or degree of difficulty in growing a company to the size and scale that would be required to achieve an IPO and support the cost of being a public company. Let me give you an example of that regulatory stress, some of which you’ve already read about. If it takes eight plus years to grow a public company, that means you’re going to have to have more investors, the company will need to be larger, and you will require more employees, many of whom require stock options as part of their compensation. So, you’re going to have a lot more shareholders than in the past, when you could go public much earlier. Once you get to 500 holders of a class of equity securities and meet a certain asset test, the ‘34 Act requires you to register as a public company and, in effect, go public. That’s a problem for private companies, who want their boards to decide the ideal timing for a public offering. If a trading market develops and you’re not in control of the number of shareholders, you might find yourself having to register as a public company before management and the board thinks you’re ready. This is a huge concern for many large private companies, as recently made famous in the press stories about the capital-raising activities undertaken by Goldman Sachs for Facebook.

A related problem for these private companies is that if private shares are traded, you may have shareholders with whom you’re not familiar, eliminating one of the benefits of being a private company—knowing who your shareholders are and where information is going. And obviously you have fiduciary duties and related liability to a set of shareholders who you may not have considered when you engaged in private capital-raising activities.

Another problem is the lack of information in private company markets.
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These markets are largely unregulated, so there are no corporate governance standards or information requirements other than the anti-fraud provisions of the securities laws and those that the market itself imposes or issuers provide voluntarily. Companies are coming up with a variety of novel techniques to deal with this, and I think it would be interesting for a student to write a paper looking at the legality and related issues of the various approaches that issuers employ to attempt to control the resale of their shares: bylaw amendments restricting shareholders selling shares, buyback provisions to manage the 500 shareholder limit, insider trading policies for private companies, etc.

In the few minutes I have remaining, let me comment on SEC policy and some thoughts for dealing with some of this stress. I do think that the SEC has been responsive in many areas, including reacting positively to the recommendations of the SEC Advisory Committee on which I served in 2005 and 2006, mentioned in Mary’s paper. We’ve seen some progress in areas such as small-business reporting, but, in general, it’s been difficult for regulation to keep pace with developments in technology and the size and scale that private companies have achieved in today’s environment. Many aspects of policy underlying the securities laws were made in an environment that contemplated paper changing hands, not the instantaneous flow of information that we now have via the Internet.

So, the question I want to leave you with is whether there is a place for a new kind of capital market structure to take advantage of the gap that I’ve been describing. Rather than leaving these markets unregulated or letting foreign markets compete in that gap, should we fashion a solution? Foreign markets have tried to take advantage of the increase in regulation and the gap in the capital markets by endeavoring to persuade U.S. issuers to register overseas in other markets—kind of an international regulatory arbitrage play. Should we embrace these markets and regulate them in a way consistent with the investor protection mandate, but also allows these markets to be more efficient and effective? An example of this would be requiring the markets to have minimum information and governance standards, like certain director independence and audit committee requirements, albeit hopefully significantly less than the ‘34 Act, SOX, and Dodd-Frank requirements, on the theory that the types of investors who are granted access to these markets don’t need the same level of protection as less sophisticated or less wealthy retail investors.

I do think that SEC policy could be changed in a way that doesn’t impair investor protection and helps both companies and these emerging marketplaces. For example, I think you could address the 500 shareholder problem by excluding from the 500 shareholder count investors already deemed not to need registration-level protection, such as qualified institutional buyers and
accredited investors. Today, companies have an exemption from registration when selling stock to venture firms, but these same venture firms are included in the count of the number of shareholders that go into determining when a company should register under the ‘34 Act. I don’t think that’s necessary from a policy perspective. Another example is the holding period required under Rule 144. Today, if I’m a venture capital investor, I can buy directly from an issuer, but I generally need to have a holding period (to avail myself of a proper exemption and assuming I am not a large qualified institutional buyer) to sell to another highly qualified and accredited investor, such as another venture capital investor. This creates restrictions in these private markets that I don’t think are necessary from an investor-protection point of view as long as the accredited buyer agrees not to resell without similar types of provisions. For example, if Sequoia Capital can buy shares directly from an issuer, why shouldn’t Sequoia (whether or not a QIB) be able to sell stock to Kleiner Perkins without a holding period as long as protections exist so that the shares are not filtered directly or indirectly into public hands?

Another possible area of reform is a relaxation of the general solicitation prohibitions, as the SEC proposed in a limited form in an August 2007 release and as our SEC Advisory Committee recommended in 2006. This would allow new technologies to be used for capital raising activities, provided the ultimate buyer meets certain accreditation standards. This proposal seems to have been frozen by recent scandals and the Dodd-Frank workload, but it should be revitalized. The net result of these types of changes, as well as mandated information and governance standards, could be a more robust middle market that could address the gap in the capital markets and some of the issues impacting these new marketplaces and issuers. Rather than ignoring these markets or shutting them down, perhaps we should consider embracing them, regulating them in a sensible way, and making them a legitimate part of our capital market structure. I’ll close with that. Thank you for listening.