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By Jacqueline A. Kelley, Partner, Global and Americas IPO Markets Leader and Jeffrey D. Grabow, Director, US Venture Capital Leader

The boom goes on: venture capital continues to fuel the IPO surge

When the financial crisis struck, venture-backed companies battened the hatches. With access to the public markets limited, they turned to existing venture capital investors to help them weather the storm. This faith and patience has been amply rewarded. In a booming market, venture capital-backed IPOs on US exchanges surpassed pre-financial crisis levels in 2013 — and look set for another record-breaking year in 2014.

Venture capitalists have long played a vital role in helping entrepreneurs turn their vision into reality. They provide far more than just capital; they also provide the guidance, knowledge and experience entrepreneurs need to transform their enterprises into thriving public companies. This article explores the current VC-backed landscape and highlights the ways in which venture capital helps entrepreneurs along their IPO journey.

When the financial crisis struck, venture-backed companies battened the hatches. With access to the public markets limited, they turned to existing venture capital investors to help them weather the storm.
Global VC-backed IPOs

**By issuer nationality**
Number of IPO exits

**Amount raised through IPO exits (US$m)**

**By exchange nationality**
Number of IPO exits

**Amount raised through IPO exits (US$m)**

Data as of 15 Sep 2014; Source: Dealogic, EY research
A quick look at the landscape

Predictions of a strong 2014 have borne fruit. Through September 15, according to EY research, there were 66 venture-backed IPOs on US exchanges, just 4 offerings short of the total for all of 2013.

On US exchanges, VC-backed IPO volume and proceeds in the first half of 2014 were more than double those of the same period a year earlier.1 The one-day return in the first half was 20.7% — down from last year’s astounding 30.49%, but still marking the third straight year of returns above the 20% mark. In line with historical trends, the health care and technology industries are driving the surge.

The advent of the cloud and of “freemium” software has given companies the ability to get up and running without the benefit of deep pockets, allowing venture capital to invest later in the company’s lifecycle. A snapshot of technology companies in the enterprise sector provides a useful example. Venture investments in the early-round stages have fallen, with the median deal size 20% to more than 50% smaller across all markets, with the exception of Europe. The average seed round investment is less than $1 million, down from $1 million to $2 million 10 years ago. At the same time, later round median values have increased by nearly 1.5 times in India, China and the US, and by nearly 4 times in all other markets.2

On US exchanges, VC-backed IPO volume and proceeds in the first half of 2014 were more than double those of the same period a year earlier.

The effect of the JOBS Act

The Jumpstart Our Business Startups Act (JOBS Act) may have had something to do with these impressive numbers. The Act, which was signed into law in April 2012, was designed to make it easier for smaller companies to attract capital and go public. These smaller companies, called emerging growth companies (EGCs), now dominate the US IPO market, representing 84% of the IPOs that have gone effective.3

The Act defines EGCs as those companies with less than $1 billion in revenue. It offers these companies the opportunity to take advantage of these key provisions, among others:

- Submit their registration statements and respond to SEC comments confidentially
- Provide 2 years of financial statements and selected data (instead of 3 years and 5 years, respectively)
- Limit executive compensation disclosures to their top 3 officers, rather than the top 5, and omit the compensation discussion and analysis
- Follow private company effective dates for new or revised accounting standards

About 85% of all EGCs that have filed since the JOBS Act became law have taken advantage of the confidential review process, while 94% have opted to file reduced compensation disclosures and just over half — 53% — have chosen to file two years of financial statements and data.

Substantially all of the growth in IPOs on US exchanges in 2013 and 2014 has come from companies in the EGC category.4

The boom has also been driven by the increasing confidence of institutional investors, who have returned to the market in force. In our 2013 report on institutional investors, 82% of those surveyed said they had invested in IPOs in the previous 12 months.5

There’s no substitute for being prepared

Going public has become an increasingly attractive option for venture capital, with the percentage of VC-backed companies going through a public offering doubling in recent years, to 14% from 7.7% in 2009, according to Dow Jones VentureSource.

1 Venture Capital Insights, 2Q14, EY, 2014.
2 Ibid.
4 Ibid.
5 Right team, right story, right price: institutional investors support IPOs that come to market well prepared, EY, 2013.
EY is the undisputed leader among the Big Four firms in taking companies public. Our experience working with high-growth, high-impact entrepreneurs has taught us that thorough preparation is the key to success, both during and after the offering, for companies intending to go public. Companies that outperform the market are typically those that begin their preparations early — 18 to 24 months before the IPO. And as key advisors and members of the board, venture capital investors can help guide their portfolio companies through this value journey.

Our experience has also taught us that it’s all too easy to underestimate the challenges involved in going public. Venture capitalists provide invaluable help in meeting those challenges, but even so, identifying the top areas of focus can be a very useful exercise. Here are 10 areas that have a direct impact on the success of a public offering.

Prepare for the journey

The IPO, in and of itself, is not the end goal. Rather, it’s a milestone event in the transformation from a private company to a public enterprise. During the process, it’s best to start acting like a public company as soon as possible.

The company should create a formal, comprehensive IPO readiness plan and a detailed timeline. Remember that the legal, technology, financial and risk management infrastructure required to operate as a public company will take time to build. The company will also need time to address the key financial accounting and reporting issues; part of this process will involve deciding whether to take advantage of the reporting provisions of the JOBS Act.

Source: Dealogic, June 30, 2014
Keep your options open

Keep in mind that an IPO isn't the only way to bring in needed funding; private capital or a strategic buyer may be an easier and more cost-effective solution. And throughout the lengthy preparation process, companies looking to go public should have a Plan B ready in case the IPO window closes.

The best way to maximize the value of a company is to prepare for more than one funding option — to “multitrack.” With that in mind, companies should evaluate their potential M&A evaluation versus their public company valuation. Although venture capitalists are turning to IPOs more frequently, significantly more companies achieve a VC exit through M&A every year.

Time the market

There's no substitute for getting the timing right. The goal is to maximize the company’s valuation not only on the day, but in the months and years that follow. But bear in mind that rushing to the market can have serious, and sometimes disappointing, repercussions, such as a sharp drop in the share price after the IPO or even no IPO at all.

Board members and management teams should view the process with a healthy skepticism. They should avoid “launch fever” by asking whether the company is ready for the public market, rather than the obverse. And they should solicit input from a broad range of external advisors, including equity capital markets advisors, investment bankers, attorneys, auditors and others. Board members, in particular, should ask: “What is your Plan B?”

The best defense against a rush to IPO is thorough preparation, including a comprehensive evaluation of all available funding options. A well-prepared company that is truly ready can move quickly when the window opens and make the most of its opportunity.

Build the right team

Investors are looking for companies that have strong, experienced management teams with a proven track record of taking companies public. The vast majority (90%) of institutional investors focus on the quality of a company's management. 

Companies that outperform during and after their IPO typically lay the groundwork by building and shaping their management team one to two years in advance of the offering, giving the team time to mesh well before the launch. It’s also a good idea to develop a strong set of external advisors who have extensive experience in IPOs. The right external team can help companies anticipate questions and issues before the market raises them.

Investors are also looking for a CEO who can tell a compelling story about the company’s vision and strategy and who inspires confidence that the company can execute on that strategy. The CFO, in turn, must be able to communicate the financial results and their context effectively.

Build your processes and infrastructure

The transition from private company to public enterprise requires a transformation of business and financial processes and infrastructure. A robust infrastructure can facilitate regulatory compliance, guard against exposure to risk and provide effective market guidance.

Many newly public companies are challenged by the need to provide timely, accurate quarterly statements and forecasts — an essential part of meeting public investors’ expectations. Board members and management must work to make sure that the right reporting processes, and the appropriate information technology to support those processes, are in place. This is an area that practice makes better, if not perfect: we suggest that companies build their quarterly forecasting and reporting infrastructure well in advance of the IPO. Management should be able to:

- Access the data it needs to make the right decisions
- Monitor (and analyze) execution against corporate goals
- Answer analysts’ questions quickly

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7 EY's guide to going public, EY, 2012
Effective internal controls are also vital, and they too should be subject to intensive testing before the launch. Regulators in the US and across the globe are looking at the effectiveness of internal controls with increased focus and reduced tolerance. A solid framework of cost-effective internal controls is a must.

It’s also important to make sure that the IPO process does not overwhelm the company’s resources. IPO candidates need to find the balance between selling the transaction and running the business. The board and management should determine who will run the company’s day-to-day operations while top executives focus on the sale process and managing the investor and analyst community.

Establish the corporate structure and governance

Building the right board for a public company is a much more complex task than in the past. Regulators require that a public company board have a majority of independent members and include audit, governance, compensation and compliance specialists. The company’s future requires that the independent directors who join the board bring the right mix of skills to complement the management team. And investors increasingly expect to see corporate governance treated as a priority.

Our research has shown that investors are seeking independent board leadership, annual director elections, diversity and independence in board composition, and “one share-one vote.” IPO bound companies should be able to demonstrate that they are meeting these goals or have a plan to do so.  

In general, it’s a leading practice to build a board that features a diversity of backgrounds and experience — as well as the ability to reach consensus. Note that gender diversity on the board makes good business sense: recent research has shown a strong correlation between mixed boards and better returns.

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8 Charting the right course: meeting investor expectations for board governance of IPO-bound companies, EY, 2014.

9 André Chanavat and Katharine Ransden, Mining the metrics of board diversity, Thomson Reuters, 2013.
Typically, a small-cap company board should have five to six outside directors with a minimum of three independent committees (audit, compensation and governance/nominating). Companies should start recruiting board members early; directors must be able to commit to at least 200 hours a year, and just like in any other field, there is fierce competition for top talent.

As part of its compliance with Sarbanes-Oxley, the company must draw a clear line between the scope of directors’ duties and management’s responsibilities. The company should also develop an appropriate succession plan as well as a deep management bench.

Manage investor relations and communications

A public company’s success rests in significant part on frequent and transparent communications with stakeholders regarding the company’s performance. During the IPO process, the investor relations function should:

• Sustain the market’s interest
• Communicate with shareholders
• Attract new investors and sell-side coverage

IPO candidates should hire a skilled investor relations professional with IPO experience to help develop a strategic communications plan and to fine-tune the company’s story and its investment value proposition.

Conduct a successful road show

The road show is a critical, and exhausting, part of the IPO journey. Management should expect to spend 5 to 10 days in the US, with an additional 1 or 2 days in Europe or Asia if appropriate. The road show represents top executives’ best chance to share their vision and to answer questions from investors and analysts.

Executives should develop a well-designed “elevator pitch” and talking points to make the most of the direct access a road show provides. But it’s also important to remember that in today’s information age, most investors have access to the information they need. The road show offers executives an opportunity to turn that information into an effective, compelling story.

Attract the right investors and analysts

Once a company goes public, it becomes accountable to hundreds or even thousands of investors where before it may have answered to a select few. Before the launch, management should focus on building channels of communication to potential investors and analysts; after the launch, management should keep those channels open.

Even with the best of offerings, it’s hard to sustain the positive momentum of the launch. Once the company goes public, it must sustain that interest by re-telling and fine-tuning its story as part of an ongoing dialogue with analysts and investors. In particular, companies should get to know the analysts covering their industry.

Last but certainly not least, management must learn to hit its targets and manage expectations. Projections and forecasts must be accurate and attainable, and the company must consistently hit its targets. At the same time, bad news is inevitable at some point; a negative response by the market is not.

Deliver on your promises

The real work begins once a company has gone public. Management must meet or beat the expectations it has set, starting with the best use of the IPO proceeds. For a company to prosper over time, investors must believe in management and its ability to execute on the corporate vision.

In today’s chaotic business environment, there are many factors outside of management’s control. To survive and thrive, management should demonstrate operational excellence: executing on its business plan, meeting financial targets consistently and attracting the right investors.
Getting on the right path

Today’s market presents an unparalleled opportunity for companies looking to go public, with venture capital playing an increasingly large role. With the JOBS Act simplifying the process — and, more important, reducing the risk of early exposure — companies have been increasingly willing to step forward. VC funds, in turn, have been increasingly willing to have their portfolio companies test the waters confidentially.

Our experience as the market leader has taught us that the IPO candidates most likely to succeed as public companies are those that view the IPO not as an event, but rather as part of a transformation process that encompasses the entire enterprise. They take the time to make sure that the necessary changes are embedded in the organization’s culture. With their knowledge and experience, venture capitalists are ideally placed to help guide that transformation — and to sustain corporate growth. As investors and advisors, they guide their portfolio companies in finding the right exit strategy, building strong management teams and developing the right infrastructure and governance.

By investing their money, energy and knowledge in high-growth, high-impact companies and bringing well prepared, well qualified companies to market, VCs are helping to maintain the market’s momentum — and keeping the window wide open for many more public offerings. They’re helping bring the latest ideas and technologies to market. They’re harnessing and unleashing the creative energy that creates wealth and jobs. In helping entrepreneurs turn their vision into reality, they’re growing the economy — and helping to build a better working world, just as we’re committed to helping these companies make the most of going public.

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Lessons of a New Investor –
Listen to the Market, Build the Ecosystem, Reap the Rewards

By Jody Holtzman, Senior Vice President, Thought Leadership, AARP

Three and a half years ago AARP established a new department called Thought Leadership. As a mission-driven organization, we set the goal to stimulate innovation in the market that will benefit people 50+. This focus was purposefully aligned with AARP’s overall mission, to enhance the quality of life for all as we age.

We knew early on that if our goal was to stimulate innovation we needed to be close to the innovators, and the investors and ecosystem that nurture them. What we didn’t realize at the outset was that we needed to find ways to nurture the innovators and help build the ecosystem.

The key was to figure out how we could add unique value to stakeholders in this emerging ecosystem. By doing so, we are now on the path to a virtuous cycle of innovation and investment activity focused on the needs of people 50+ and the business and investment opportunities they present.

The key takeaway for the venture capital community is that everything we have done and learned, has confirmed that there is a large and growing investment opportunity for venture firms in the Longevity Economy.

- There are investment-worthy startups looking for investment.
- There is more investment activity in the 50+ space than most realize.
- Top venture capital firms are interested and active in the 50+ space.
- Exits have been few, but they returned strong multiples.
- The 50+ are driving economic growth.
What we have learned is that our efforts to build the ecosystem supporting companies addressing the needs of people 50+ is a key to lowering the barriers to greater venture capital interest and investment. It has helped startups in this space raise capital. It has also helped AARP to identify new innovative companies with products and services for us to make available through our distribution channels for the benefit of our 38 million members. And this experience also has helped to confirm that AARP should add its name to the list of investors that are funding innovative startups of relevance to people 50+.

An Emerging Ecosystem Focused on People 50+

For the past 11 years, an event has been held in Santa Clara called the Silicon Valley Boomer Venture Summit. This international business plan competition brings together VC judges and entrepreneurs focused on the 50+ and is the brain-child of Mary Furlong, an entrepreneur in the nineties who founded Senior Net and then ThirdAge Media, for which she raised upwards of $100 million in venture investment. She has become a professor of entrepreneurship at Santa Clara University, the venue of this event of which AARP is a long-time sponsor.

The significance for AARP of the event is that it was the first to introduce us to the nascent ecosystem of startups and VCs invested in companies focused on people 50+, of which there were several prominent firms such as Kleiner Perkins, Draper Fisher Jurvetson, and Intel Capital, among others.

But this emerging ecosystem also faces challenges.

Venture Capital Firms. VCs viewed and in many cases continue to view this market opportunistically, rather than through the lens of an investment thesis. Many equate using a 50+ lens with sub-optimal financial returns. Few VCs understand the 50+ consumer, their needs and wants, and the buying and other behaviors associated with the various disruptive life stages that comprise this group of people numbering more than 100 million. And lastly, most VCs view the 50+ space as new and risky - unaware of the large amount of venture investment that has in fact occurred in this space, but which has not been neatly bucketed into a bite-size name category, such as Internet, Big Data, SaaS, Life Sciences, Digital Health, Education, Enterprise Software, etc.

Startups. Startups in this space have their own challenges. Despite there being no shortage of startup activity focused on the 50+ over the past several years, adoption of products and services is slow – especially in the direct-to-consumer sphere. As we noted in a report we produced with Parks Associates, product and service adoption is slow in part because “current market solutions are not meeting many of the needs and desires of this key consumer demographic” (Health Innovation Frontiers, 2013). Several factors were identified:

- Poor design and aesthetics.
- A tendency to focus marketing on society’s sickest, most frail, and oldest.
- Lack of easy connectivity and interoperability to share data via the Internet or with other devices, limiting the utility of collected data.
- The belief that cutting-edge technology is only suitable to younger people.
- Low awareness among older consumers of many cutting edge solutions and services.
- High cost of direct-to-consumer solutions, pricing some segments of high-need older consumers out of the market.
- A fragmented approach to addressing older consumers’ needs when a more comprehensive solution would drive higher usage.
- Designs that fail to incorporate the role of adult children and caregivers.

Despite there being no shortage of startup activity focused on the 50+ over the past several years, adoption of products and services is low – especially in the direct-to-consumer sphere.
In addition, many startups in the 50+ have business models that won’t scale. And although AARP is supportive of these companies and wishes them success because they are addressing important needs and wants of our constituents, many of these startups also are not attractive to AARP either for our distribution channels or investment, as we seek out new products and services for our members.

To address these challenges and achieve our goal to stimulate greater levels of innovation that will benefit people 50+, we consciously set out to add value by helping lower the barriers to success, for both venture capital firms and startups.

**Understand the Market**

When we speak with some VCs about the investment opportunity in the 50+ space, it is clear that there is still a lack of awareness regarding the scale of unmet needs waiting to be addressed by innovative startup companies. The good news is this a declining number. But it is still prominent.

So how should the venture capital industry understand the 50+ space? There are two distinct but related “buckets” of opportunity.

The one most identify is comprised of companies designing products and services explicitly focused on serving people 50 and older. Many of these products and services address the evolving needs of individuals, their families and caregivers that are associated with the physical decline of aging and declining health. This represents a large number of people and a sizeable market and investment opportunity. Within the health and wellness space, for example, this includes things such as aging with vitality, vital sign monitoring, medication management, emergency detection and response, and care navigation.

The larger market and investment opportunity includes products and services of equal relevance to people 50+, as well as those in other age categories. Within the health and wellness space these include physical fitness, diet and nutrition, social engagement, and behavioral and emotional health. But because aging involves the entire family, categories such as those above also are of interest and address the needs of people of many ages.

And beyond the health and wellness space, the 50+ have evolving needs and wants involving financial security, as well as multiple areas contributing to personal fulfillment and leisure, presenting large additional opportunities for innovation and investment.

**One Size Doesn’t Fit All.** Venture investors need to have a detailed understanding of the markets they invest in so as to increase the likeliness of success and mentor their portfolio companies accordingly. And while most VCs have this understanding in their target verticals, it is less the case with regard to the 50+

For example, remote monitoring is a significant product and service category that directly responds to the needs and desire of older people to remain in their homes and continue to live independently as long as possible. One established segment of this market, personal emergency response systems (PERS), is a $1.5 billion market and growing (Aging in Place Technology Watch). In addition to serving the needs of the older adult, remote monitoring also responds to the need and desire of adult children for peace of mind with regard to the safety and comfort of their older parents.

Given the above, a company selling a remote monitoring solution confronts two separate sales – although only one of them is a financial transaction.
In many cases, the adult child may be the buyer who engages the company in a financial transaction. And the adult child, in many cases a baby boomer, may be willing to pay a premium for the peace of mind the product and service provide.

But, once a financial sale is made, another transaction is necessary. That is to convince the older person to allow the product to enter their home. This is not a financial transaction. But it is no less a transaction. The unique character of this total sale, is that it requires two separate positionings and value propositions – one for the adult child, and one for the older parent.

Most VCs with experience investing in health IT may have deep knowledge of the technology and perhaps its use and roll-out in institutions, where the value proposition is different than in a direct to consumer transaction. But, to help a portfolio company that has a great technology with D2C potential, VCs also need to understand the dynamics influencing consumer demand for such products. And these dynamics are unique in many cases. For the most part, they are not driven by age.

In fact, an age focused go-to-market strategy is likely to fail. There are over 100 million people 50+. Among these, around 40 million who are over 65. In both cases this is more people than are in most countries.

People the same age are in different life stages with different life styles. A person in their late 50s may be an empty-nester and grandparent without living parents. Another person the same age may have kids in high school and older parents – the classic sandwich generation. People in their 80s may face health issues that greatly impact their quality of life and determine their daily schedule by imposing multiple and frequent doctor’s visits. While others the same age in relatively good health are active and planning the next trip overseas.

VCs with portfolio companies in this space need to have an understanding of such factors, both to provide guidance for their companies and to assess what their CEOs understand about their target market.

**Come On In, The Water’s Fine**

At a meeting a few years back with a managing partner of a major VC firm, I asked why there hadn’t been more investment activity in this space. The response was: “Because there haven’t been any large exits.” Translation – nothing sizeable enough has occurred to rivet the attention and stimulate the herd mentality of Silicon Valley.

It’s true. To date, of the startups explicitly focused on a 50+ or older market, few have had exits. But, of the few that have, they had strong multiples. These include Extend Health, Vitality Glocaps, and Caring.com, each reportedly returning 10X or better to their investors. Extend Health (now OneExchange) had the largest exit. A former Psilos portfolio company, Extend Health was bought by Towers Watson for $435 million following its IPO filing. While this is not a Facebook-size exit, these are returns that any venture fund should like to have.

There appears to be a domino effect at work. The lack of exits has led to a lack of interest. And the lack of interest has led to a lack of awareness about the sizeable level of startup activity and investment. As a result, there continues to be VC resistance to focusing on the opportunity presented by the demographic age wave.

Sizeable investments have in fact been made. We worked with one of our partners, Startup Health, to identify and size digital health investments focused on the 50+ and remove some of the mystery and perceived risk about this market.

The definition we applied was a broad one, in order to capture the full scale of the investment activity in the digital health space for the 50+. The definition we used is — Products and services of relevance to people 50+ across the nine categories of aging with vitality, medication management, emergency detection

**Sizeable investments have in fact been made. We worked with one of our partners, Startup Health, to identify and size digital health investments focused on the 50+ and remove some of the mystery and perceived risk about this market.**
and response, vital sign monitoring, care navigation, behavioral and emotional health, social engagement, physical fitness, diet and nutrition.

In recent years (2010 to 2013), we have seen tremendous growth in total digital health and wellness investment (from $1.05 billion to $2.8 billion). Deal count more than quadrupled from 128 to 527 deals (source: Startup Health Insights).

In the digital health space relevant to people 50+, on the other hand, funding grew from $0.56 billion in 2010 to $1.5 billion in 2013, representing 53 percent of all digital health investment dollars in both years. The number of deals increased from a total of 67 deals to 311 deals, accounting for a rising share of deals from 52 percent to 59 percent (source: Startup Health Insights). This is significant investment by anyone’s definition. Glocaps are all reported to have returned 10X or better to their investors.

The 50+ are driving economic growth. They account for $3.1 trillion in consumer spending, $1.6 trillion in healthcare spending, control 80 percent of net worth, and dominate consumption in most CPG categories, as well as financial services, and travel and leisure.

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Since 2010, Aging with Vitality, Vital Sign Monitoring and Care Navigation received the greatest amount of digital health VC funding in the 50+ space. Physical Fitness and Care Navigation saw the greatest number of deals.

With regard to growth stage of the deals, most of the deals in companies relevant to the 50+ have been in early-stage innovation, with 50 percent of all the deals in the 50+ market either Seed or Series A rounds.

So, which venture capital firms are making these deals? Startup Health identified the following top 12 firms funding digital health startups in the 50+ market (see the table below).

The interesting fact is, most of these venture capital firms would be surprised by the conclusions of Startup Health’s analysis, i.e. that they are the top investors in the digital health space relevant to people 50+. Why? Because they are not making these deals with an investment thesis built around the Longevity Economy or the 50+.

This logically leads to a question – so AARP, if investments of relevance and benefit to people 50+ are being made anyway, without an explicit Longevity Economy investment thesis, who cares? And the answer is – because without an explicit thesis that focuses investment deal sourcing proactively, despite the level of investment, it is missing out on even greater opportunity. It is reactive and therefore, by definition, sub-optimal. It is sub-optimal for the VCs who are missing out on greater deal flow and opportunity, for startups in this space, and for our own goals to stimulate greater innovation that will benefit people 50+. It also is sub-optimal for AARP’s future investment efforts, which will benefit from partnering with VCs who are on the lookout for deals in this space.

Health Innovation@50+ LivePitch

As we have looked at how we at AARP can have a material impact in stimulating greater levels of innovation that will benefit people 50+, we have identified several opportunities and requirements. The key, as in other verticals, is greater deal flow of more quality companies that are investment-worthy. So the question for us became - What can we do to ensure that more investment-worthy companies of relevance to the 50+ are viewed by more VCs and Angels?

The most important decision we have made to date was the creation of a new franchise, Health Innovation@50+ LivePitch, which has become a destination for startups, investors, industry, and consumers over the course of three events.

The first Health Innovation@50+ LivePitch event was held in New Orleans in 2012. Since then two more events were held in 2013 in Las Vegas and in 2014 in Boston. Over the three events, thirty finalist startup companies appeared on stage in front of an audience comprised of venture and angel investors, corporate VCs, industry, and consumers (AARP members). We have leveraged the AARP eco-system by tying these events to AARP conferences that typically draw 10,000-15,000 consumers and more than 100 established companies.

### Top 12 Firms Funding Digital Health Startups in the 50+ Market

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Source: The Top 12 Venture Capital Firms Funding the 50+ Market; A Startup Health Insights Report, 2014
The event has attracted a strong contingent of VCs who volunteered as judges, including: .406 Ventures, Cardinal Partners, Comcast Ventures, Draper Fisher Jurvetson, Google Ventures, HLM Venture Partners, Interwest, Khosla Ventures, Kleiner Perkins, Maveron, Physic Ventures, and Psilos. We also have had industry participants including Aetna, Humana, Pfizer, TEDMED, Walgreen, and United Health Group. Several of our judges have previously invested in the 50+ space, and a few have now invested in some of our finalists.

Not Just Another Demo Day. There is no shortage of demo/pitch days, starting with DEMO the granddaddy of them all. So, when we first began to consider holding our own demo/pitch day, we quickly concluded that it only made sense to do our own if it added unique value compared with others. The key was to think about the assets that AARP has that others do not. The most significant of these is AARP’s access to the consumer – AARP members.
This was something that was driven home to us early on as we met with VCs and entrepreneurs. We asked them, in our effort to stimulate innovation of relevance to the 50+, what could AARP do that would add unique value? First, VCs said, “If you want to stimulate innovation, put some skin in the game and invest.” That was quickly followed, from VC and entrepreneur alike, with an additional response - “Give us access to your members, to conduct pilots, test products, and get market feedback.” Our LivePitch event is designed to do just that.

Health Innovation@50+ LivePitch is unique. In addition to pitching to a judges’ panel (and audience) of VCs and prospective investors, the entrepreneurs also pitch to consumers, who also are in the audience.

Upon entering, the AARP members are given real-time voting devices. Following the pitch and the back and forth Q&A with the VC judges panel, the consumers are asked to vote on three questions:

• Is the product/service unique?
• Does it address a significant need?
• And, would you use it or refer it to family and friends?

The voting results appear immediately on the stage screen for all to see. Through this double vote process we have a Judges’ Choice, and Consumers’ Choice winner. In one of the three events, the same company won both awards. For the other two events VCs and consumers chose different winners each time.

Results of Participation in Health Innovation@50+ LivePitch. To obtain feedback and input to improve our event, we recently conducted a survey of finalists that participated in each of our three Health Innovation@50+ LivePitch events. We learned the following:

• Of our first 30 finalists, 15 have raised capital – a total of about $48 million for early stage companies.
• Another two companies exited through acquisition, including our Boston Judges Choice winner, Lift Labs which was recently acquired by Google.
• Of those who raised funding, roughly 70 percent raised a Seed Round, 53 percent an A Round, and 6 percent a B Round, with a few raising more than one round.

Virtually all of the finalists included as part of their pitch to investors their selection and participation in AARP’s Health Innovation@50+ LivePitch. All of them stated that their selection as finalists helped them raise capital, primarily because it gave them market validation in the eyes of prospective investors. And for several others, their participation in LivePitch led to distribution deals with AARP and/or others.

The startups received investment from both VCs and angels, including .406 Ventures, Accelerator Ventures, Band of Angels, Blue Cross Blue Shield Venture Partners, Jonathan Bush, Cambia Health, Mark Cuban, Maveron, Mountain Group Capital, Sandbox Industries, and TriStar Technology Ventures. A UK-based company raised money through Crowdbnk and Clearly So.
Most finalists found the market feedback they received from consumers (i.e., AARP members) of value, in the voting and/or interaction on the trade show floor.

To provide finalists with an additional opportunity to get consumer feedback and interact with AARP members, starting at our second event in Las Vegas we provided exhibit space on the trade show floor over the three days of AARP’s annual Life@50+ Event and Expo. Holding our LivePitch at AARP conferences ensures a steady stream of consumers.

Most finalists found the market feedback they received from consumers (i.e., AARP members) of value, in the voting and/or interaction on the trade show floor. Finalists told us their consumer interactions:

- Helped confirm pricing models.
- Led to a reassessment and the introduction of a new and better technology solution.
- Provided an opportunity to test different positionings resulting in a re-crafted value proposition.
- Led to software modifications more responsive to older consumers.
- Helped refocus the product development strategy.
- Opened doors to distribution deals – with AARP and others.
- And, provided helpful feedback on design.

One finalist summed up their experience with AARP members as “a focus group on steroids.”

This type of real-time market feedback and interaction with targeted consumers is something that most startups lack in any vertical. And it is a unique value-add that AARP can provide. We are now in the process of exploring ways that we can scale this consumer interaction so that more startups can gain market feedback and consumer input with AARP members and others 50+

Conclusion

As the title of this article states, we have learned several lessons through our effort to stimulate innovation in the market that will benefit people 50+. And by contributing and building the Innovation@50+ ecosystem, we have reaped important rewards. Most significant has been growing interest in the 50+ space, by venture capital firms, entrepreneurs, and others. While we have built upon the work of pathbreakers such as Mary Furlong and Ken Dychtwald, still others have built upon ours. And at each stage, we have grown our network of startups, VCs, industry, academia, media, and others. The result is a stronger ecosystem that is become self-reinforcing, with greater deal flow and investment as a result. We can rightly claim that this is, in part, due to our work. It also is a model to build on for strategic investors.

Another “reward” of this effort is the conclusion we have come to. That in addition to driving deal flow for others, we are now part of a set of relationships that present investment opportunities for AARP as well. And with the establishment of our own fund, to put additional “skin in the game” so as to further stimulate relevant and beneficial innovation for people over 50 and others, as well as earn financial returns like other investors, but for the purpose of putting it to work to further our mission – to enhance the quality of life for all as we age.
Takeaways for VCs

There are investment-worthy startups looking for investment. We have limited capacity for our annual Health Innovation@50+ LivePitch. We only put 10 finalists on stage at each event. This past year, that was 10 of 193 applicants. And reflecting the critical mass of deal flow in this space, we alone have had 400 applicants over three events in two years. Of our first 30 finalists, 15 raised about $48 million and another two exited through acquisition. There are other investment-worthy companies that simply have not had the exposure or have had difficulty opening doors.

There is more activity in the 50+ space than most realize. In the digital health space alone, companies relevant to the 50+ raised $1.5 billion in 2013 and made up 53 percent of total funding in digital health. And this doesn’t include opportunities in other verticals.

Top venture capital firms are interested in the 50+ space. The venture firms that have volunteered as judges at AARP’s Health Innovation@50+ LivePitch include: .406 Ventures, Cardinal Partners, Comcast Ventures, Draper Fisher Jurvetson, Google Ventures, HLM Venture Partners, Interwest, Khosla Ventures, Kleiner Perkins, Maveron, Physic Ventures, and Psilos. Several have formal initiatives focused on the opportunities presented by the growing population of people 50+.

Exits have been few, but they returned strong multiples. Extend Health, Caring.com, and Vitality Glocaps are all reported to have returned 10X or better to their investors.

The 50+ are driving economic growth. They account for $3.1 trillion in consumer spending, $1.6 trillion in healthcare spending, control 80 percent of net worth, and dominate consumption in most CPG categories, as well as financial services, and travel and leisure. Their lives are filled with disruptive events that demand new solutions and change consumer behavior. And the product and services categories they purchase from, are ripe for disruption.

What are you waiting for? What’s your 50+ strategy?

About the Author

Jody Holtzman has more than two decades of experience helping companies develop and implement competitive strategies and achieve their strategic market goals. At AARP, he leads the Thought Leadership group, where his focus is to stimulate innovation in the market that benefits people over 50. This involves areas such as the future of technology and the 50+, technology design for all, and 50+ entrepreneurship. It also involves developing partnerships with non-traditional players for AARP, such as the venture capital community, and the consumer electronics and technology industries. Previously, Jody led AARP’s Research and Strategic Analysis group.

Before joining AARP, Jody was in senior leadership roles in several strategy consulting firms. He was a Director of Global Strategy and Planning, and led the Market Intelligence Network of PricewaterhouseCoopers. Before that, he was Vice President of Consulting for FutureBrand, where he helped clients develop and implement competitive brand strategies.

Jody is a frequent speaker on the opportunities and challenges presented by the demographic wave. He has led numerous workshops on competitive strategy and organizational performance, and his work has been published in the Journal of Business Strategy, Competitive Intelligence Magazine, The Competitive Intelligence Anthology, and Making Cents Out of Knowledge Management. He has a graduate degree in international political economy from the University of Chicago.
Increasing LP and Regulatory Scrutiny. Is it here to stay?

By Steven Nebb, CFA and David L. Larsen, CPA, Managing Directors of Duff & Phelps LLC

The Venture Capital Industry fought hard to be exempted from provisions of the Dodd–Frank Wall Street Reform and Consumer Protection Act (known as Dodd-Frank), signed into law in 2010. Further lobbying during the SEC’s Dodd-Frank rule making process allowed many VC managers to escape formal registration requirements. VC firms have historically operated in an environment with limited government regulatory impact. Yet the long-arm of regulation seems to be reaching VCs through certain aspects of fund administration, especially related to valuation. Additionally, limited partners (LPs) seem to be asking more and more questions. Why is this the case and how should VC managers deal with the increasingly bureaucratic and questioning environment?

In the United States Dodd-Frank requires certain Investment Managers to register with the US Securities and Exchange Commission (SEC) resulting in ongoing SEC oversight and inspections. Further, auditors of such regulated entities also face additional Public Company Accounting Oversight Board (PCAOB) and SEC scrutiny. In Europe, the Alternative Investment Fund Managers Directive (AIFMD) entered into force in 2013. AIFMD imposes far reaching rules that will have a profound impact on AIFM’s general operations, and in particular the way fund managers communicate and interact with investors and other stakeholders. An aspect of AIFMD that has not garnered the same level of press coverage as other areas of the Directive is the requirement for independent valuations.

Addressing investor, auditor and other stakeholder concerns around the issues of subjectivity, transparency and judgment that are inherent in the valuation of illiquid investments is a focal point
While uncertainty and change are ever present, it must be definitively stated that most institutional LPs have need for timely, periodic, robustly estimated net asset values supported by a rigorous measurement of the Fair Value of underlying investments.

of the AIFM Directive’s valuation requirements, is a component of SEC inspections of Registered Investment Advisors and is increasingly a concern of LPs. While many VC managers are exempted from Dodd-Frank registration requirements and many US VC managers may not be subject to AIFMD scrutiny, because of the pervasive regulatory environment for larger private equity managers, there is a spillover indirect impact on the VC community.

Financial legislation around the globe continues to drastically change investment managers’ regulatory reporting obligations. Investment managers face multiple challenges in this environment, including:

- Geographically diverse regulatory reporting requirements;
- Tight reporting deadlines;
- Multiple reports with common data requirements, but slightly different formats;
- Large volumes of data which are sometimes sourced from disparate systems and/or vendors; and
- The need to enhance data elements from outside sources to satisfy requirements.

It is beyond the scope of this article to describe all regulatory impacts direct and indirect. Rather, we will focus on the indirect impact regulation in general, and the expanded scrutiny on LPs specifically, as both factors directly impact VC managers with respect to valuation, financial statement preparation and annual audits.

Fair Value Reporting: Objectives and Challenges

As we have discussed in previous articles, one of the most difficult responsibilities faced by a fund’s CFO or controller is articulating to both fund investors and deal professionals the technical background and pragmatic reasons for determining and reporting Fair Value. At times, it seems as though both general partners (GP) and limited partners (LP) do not fully understand the reporting and disclosure needs of the other.

Further, the failure to communicate why specific information is needed by GP and LP organizations, has given rise to more detailed limited partner agreements, requests for side letters, ad hoc data requests, and LP initiatives such as the ILPA Private Equity Principles. Further, in 2015 the Government Accounting Standards Board (GASB) expects to implement a new Fair Value accounting standard which is substantially similar to FASB’s ASC Topic 820 and IASB’s IFRS 13. This means that there will be renewed valuation scrutiny on LPs, especially government sponsored pension plan investors, to take steps (as described below) to better understand and dissect the Fair Value estimates included in Net Asset Value (NAV) as reported by the GP.

While uncertainty and change are ever present, it must be definitively stated that most institutional LPs have need for timely, periodic, robustly estimated net asset values supported by a rigorous measurement of the Fair Value of underlying investments. Historically, LPs have not always expressed the reasons why they need Fair Value reporting. These reasons include, but are not limited to, the following:

- Fair Value is the basis investors (LPs) use and are required to use to report periodic (quarterly/yearly) performance to their investors, beneficiaries, boards, etc.
- Fair Value is the best basis for LPs to make apples-to-apples asset-allocation decisions.
- Fair Value is an important data point in making interim investment (manager selection) decisions on a comparable basis.
• Fair Value is often necessary as a basis to make incentive-compensation decisions at the investor level.

• LPs need consistent, transparent information to exercise their fiduciary duty. Fair Value provides such information on a comparable basis for monitoring interim performance.

• An arbitrary reporting basis such as cost does not allow comparability.

• Most investors are required by relevant GAAP to report their investments on a fair-value basis.

• Investment company accounting rules require GPs to report underlying investments at Fair Value. If GPs did not report using Fair Value, they would be required to produce consolidated financial statements which would be of limited or no use to investors.

LP Perspective on Fair Value

Limited partners ("LPs") find themselves in a unique position with respect to Fair Value. LPs are responsible for reporting Fair Value to their investors for fiduciary and regulatory reasons. However, in an effort to capture consistent returns for their investors, LPs are often much more diversified than the GPs in which they invest. They also tend to employ a wide variety of investment methodologies, from direct investing in companies to fund-of-funds investing. Given the diversity in investment types and the ever-increasing number of underlying portfolio investments in which an LP may be invested, there is no question that LP Fair Value reporting can present a daunting task.

There is a considerable degree of diversity in how diligent LPs have been in their efforts to fulfill their roles in reporting Fair Value to their investors and stakeholders. LPs tend to fall in one of three main categories:

1. Blind acceptance of GP-reported NAV, with no independent questioning or assessing of GP’s process

2. Awareness of the requirements and guidance for Fair Value reporting, but are not proactive in confirming that the steps undertaken by GPs are sufficient to fulfill the LPs fiduciary duties. These LPs often assume that Fair Value disparities of any single position in their portfolio are immaterial with respect to the portfolio as a whole, and that proper oversight would be too laborious an effort to undergo. And,

3. Full awareness of how GPs estimate Fair Value (as included in NAV) and have procedures in place to confirm that valuation inputs, assumptions and approaches are being applied appropriately for each reporting period.

Due to increased regulatory and investor scrutiny, however, there is a marked trend in the LP community towards a proactive Fair Value estimation process (category 3 above). The issuance of GASB’s new Fair Value accounting standard is expected to increase the pressure on LPs to improve their own Fair Value assessment process. At a minimum informed LPs will likely begin expanding due diligence such that they only invest with GPs that have established policies and procedures that, if followed, result in a “best practice” based Fair Value estimation process which includes detailed valuation policies, well-established procedures, and just as importantly a “tone from the
In a perfect world, GPs would report Fair Value estimates to LPs on a continuous basis, just as they are available in active, public markets.

Fiduciary and Regulatory Pressures

LP management is ultimately responsible for the Fair Value measurements and disclosures included in the financial statements. In a perfect world, GPs would report Fair Value estimates to LPs on a continuous basis, just as they are available in active, public markets. Given the nature of private asset markets, however, this isn’t a possibility, and GP-reported NAVs are often untimely and/or their procedures may lack a process robust enough to estimate NAV on a basis consistent with Fair Value.

While GPs may have their own Fair Value disclosure requirements, it is not enough for LPs to simply rely on the NAV most recently provided by the GP. However, ASC Topic 820 and the new GASB Fair Value pronouncement permit LPs to estimate the Fair Value for their LP interest by utilizing the GP’s reported Net Asset Value (“NAV”) as a practical expedient, when:

• The LP has taken appropriate steps to determine that the Investment Manager’s calculated NAV is based on a rigorous determination of the Fair Value (consistent with ASC Topic 820) at the measurement date of its underlying investments;
• NAV is “in-phase” (reported NAV is as of the same date as the LP’s measurement date); and
• NAV has been adjusted to take into account the provisions of the AICPA Technical Practice Aid, “Allocation of unrealized gain (loss), recognition of carried interest and claw-back obligations”.

LP management must develop a process to evaluate the satisfaction of these criteria, and to enact a process by which adjustments, where necessary, can be made to ensure compliant, Fair Value-based reporting.

The Proactive LP and Fair Value Reporting Best Practices

There are two primary areas that LPs can pursue in order to ensure compliance with “best practice”-based Fair Value reporting:

• Enhanced oversight of GP procedures; and
• Improved internal policies and procedures.

Enhanced GP Oversight

In order to rely on the estimated NAV reported by GPs, LPs must first ensure GP compliance with Fair Value reporting requirements. LPs can accomplish this through the use of pre-investment due diligence, through ongoing monitoring of GPs, and through the establishment of LP oversight committees.

Pre-investment due diligence

Many LPs are putting a focus on Fair Value estimation as part of their pre-investment due diligence process, ensuring that the GP in which they are considering making an investment has the governance and independent expertise in place to estimate a Fair Value-based NAV after the commitment is made. Through the establishment of an investor selection process utilizing internal and external resources in order to analyze the GPs valuation policy, process and results, potential red flags can be identified before the commitment is made.

As part of this process, the LP will first obtain Investment Manager’s Valuation Policy and review it to determine if, when followed, the underlying investments would be reported at Fair Value. They will also review financial statements, Quarterly reports, annual meeting information, etc. for evidence that the fund has followed these stated procedures for existing funds. LPs will then interview GPs regarding the valuation process, data collection and information management, documentation / reporting, and any special situations that should be considered.
LPs should ultimately determine whether or not reported NAVs are based on the robustly estimated Fair Value of underlying investments, using a thorough process which timely integrates market data and uses appropriate valuation methods, inputs and assumptions. Quality GPs should have the appropriate systems and practices in place to capture market data, integrate relevant data into their valuation process, and produce a Fair Value-based NAV for their LPs.

**Ongoing monitoring**

After confirming that GPs have processes in place to estimate a Fair Value compliant NAV, it is equally important for LPs to continue to monitor GP Fair Value estimation processes.

When determining whether or not the GPs processes and procedures would result in a Fair Value-based NAV, a proactive LP considers the following factors, among others:

- What approaches does the GP utilize to estimate Fair Value, and are these appropriate?
- Are inputs and assumptions well documented, calibrated at inception of a deal, and obtained from appropriate sources?
- Does the GPs valuation process utilize independent valuation experts to validate and concur with Fair Value estimates?
- Is there empirical evidence of a robust valuation process?
- Are Fair Value estimates consistent with quarterly performance reports provided by the fund manager?
- Do changes in values of underlying investments (or NAV) make sense when compared to market trends (strategy, sector, industry, comparable index, etc.) or more importantly for VC investments, material portfolio company events?
- Are realized values congruent with valuation estimates (back testing)?
- Has there been an effort to calibrate the (original or updated) investment thesis with current company developments in deriving Fair Value?
- Are the valuations infrequent or “stale”? Do they change from reporting period to reporting period?

Ongoing monitoring of GP Fair Value allows the LP to determine whether GP-provided NAV can be accepted as its measure of Fair Value. As mentioned previously, in order to utilize a GP provided NAV, the LP must ensure that a) the NAV estimate is Fair Value compliant, b) that the NAV has been adjusted to take into account the provisions of the AICPA Technical Practice Aid, “Allocation of unrealized gain (loss), recognition of carried interest and claw-back obligations”, and c) that the value is “in-phase”, meaning that the NAV is estimated as of the same date as the LP’s measurement date.

If LP management determines that the GP’s NAV estimation is, in fact, Fair Value based, and has been appropriately adjusted for provisions of the AICPA Technical Practice Aid, the LP must then consider whether the GP reported NAV is “in-phase.” As GPs are unable to value illiquid positions in real time, it is often the case that there is a reporting lag of weeks to several months. Given this, LPs must determine whether changes to the underlying investments or market movements would necessitate an adjustment to bring the last reported GP NAV “in phase” as of the measurement date. If it is determined that the NAV is Fair Value based but “out of phase”, LP management should implement a process by which adjustments to GP reported NAV could be augmented to bring it “in phase”.

If, however, Management determines that the GP’s estimation of NAV is not Fair Value based, the LP may estimate a Fair Value based NAV as of the measurement date by determining the Fair Value of underlying investments. As this would most likely be a daunting task, the investor could estimate Fair Value using an alternative method such as:

- Estimating and modeling all future cash flows (investments/capital calls, and exits/distributions) and discounting at an appropriate rate;
- Estimating the Fair Value of an interest in a Fund based on transparent observable secondary market transaction data; and/or
- Identifying a similar fund or funds and using it as a proxy for the value of the fund being valued.

All of these factors highlight why LPs are asking increasingly more rigorous questions of their GPs.
Regulatory Squeeze of VC Managers

- In response to Enron, Congress enacts Sarbanes Oxley, which created the Public Company Accounting Oversight Board (PCAOB) to regulate Auditors
  - With the goal of not having another Enron, PCAOB inspectors find fault with auditors past procedures
  - PCAOB pressure on Auditors is viewed as the right way to make American business do the right thing
  - Materiality is discarded and Auditors are under new more stringent pressure
- In response to the Financial Crisis, Congress enacts Dodd Frank – regulating investment managers
  - Investment companies now more exposed to PCAOB
  - PCAOB finds fault with auditors fair value testing procedures
  - SEC begins inspecting Investment Managers and finds fault with valuation processes and other investor communications
- In response to the PCAOB and the SEC auditors expand valuation testing by pushing for more “auditable” models
  - Auditors find it difficult to apply different audit procedures to regulated and non-regulated investment managers
  - VC managers end up being squeezed by audit processes designed for regulated managers

Regulatory Squeeze of VC LPs

- FASB issues SFAS 157 (now ASC 820) harmonizing the definition of Fair Value
- Unit of Account question arises about the use of NAV to value LP interests
- FASB issues ASU 2009-12 allowing the use of NAV as an LPs fair value estimate
- Most LPs continue to use NAV to value LP interests, without fully implementing their own expanded scrutiny of GP valuation estimates as is required by ASU 2009-12
- SEC examination of GPs cause LPs to begin asking more questions
- GASB issues fair value exposure draft modeled after ASC Topic 820 which articulates the need for LPs to assess and evaluate GPs valuation process
- LPs begin to expand due diligence, ongoing monitoring and their own assessment of the GPs valuation process
- LPs push for greater transparency and more timely reporting
Impact of Regulation on the GP

With this background of valuation pressure on the LP, why does it appear as though more pressure is coming from auditors than questions from LPs? This is a complicated question without many clear answers. However, the most likely answer is available through a connect-the-dots analysis.

As previously noted, many VC managers are not required to register with the SEC. VC Funds include in their fund formation documents a requirement to prepare financial statements in accordance with GAAP and obtain an annual audit of the Fund financial statements. So why do many VC managers believe that the same security from auditors is applied to VC fund financial statements as those which are subject to review by the SEC? By attempting to connect the dots from the VC manager world and the LP world with the auditor environment, we can begin to see why VC managers are feeling squeezed.

One of the unintended consequences of converged Fair Value accounting standards and regulation of auditors and larger investment managers is that a one size fits all regulatory environment has de facto been established. Auditors don’t like being “slapped” by the PCAOB and so they put pressure on GPs and LPs for more robust and auditable valuation models; the SEC takes exception to practices where investment managers appear not to comply with fund formation agreements and do not have robust valuation and fundraising practices; LPs realize they must be more proactive in their approach to valuation, so they are requiring more insight and oversight, or ultimately independence, in the manager’s valuation process; and the overall valuation environment has become more rigorous.

Squeezing of the GP caused by the LPs increased need for transparency and the indirect impact of regulation is likely not reversible. However, GPs can help mitigate the increased scrutiny by establishing valuation processes and practices which clearly document valuation estimates including, but not limited to:

- Unit-of-Account—what is the security being valued?
- Calibration—how does the value of the last round of financing impact subsequent valuation estimates?
- Market Participant Assumptions—does the valuation estimate reflect the factors that would be used to determine value by potential investors?
- Value Accretion—when, how, and why does value change over time.

Clearly documenting how Fair Value is determined at each reporting date is a key factor in limiting the extraordinary scrutiny that the current pressures on auditors and LPs is driving.

Conclusion

Establishing reporting policies, executing robust valuation procedures is a key responsibility of fund managers in order to provide LPs with a rigorous assessment of the Fair Value of underlying investments. Additionally, Fund administrators must familiarize themselves with the GP’s process to ensure that information presented to investors is not misleading. LPs need timely, supportable values to ensure that their own analytical and reporting needs can be fulfilled.
One of the best sources of best practice valuation information for alternative asset investors is the International Private Equity and Venture Capital Valuation (IPEV) Guidelines. The IPEV Guidelines were created to: “Set out best practice where private equity investments are reported at ‘Fair Value’, with a view to promoting best practice and hence helping investors in private equity funds make better economic decisions.” The IPEV Valuation Guidelines were last updated in December 2012 and have been endorsed by numerous industry organizations around the globe, including, but not limited to, the European Venture Capital Association, British Venture Capital Association, AFIC (French association of Venture Capital Firms), US National Venture Capital Association, Private Equity Growth Capital Council and the Institutional Limited Partners Association.

While judgment is always necessary in developing a Fair Value estimate, a fund accountant can critically assess fair-value conclusions by honestly answering the following question (with deal team support): What would we pay for this company/investment if we were to invest today? An honest answer to this question provides a final check on whether or not the steps articulated above result in an estimate of the price that would be received in an orderly transaction on the measurement date. Fair Value is an important tool for both GPs and LPs. It is a necessary and helpful basis for reporting. Utilizing a process that is rigorous, robust, and which properly applies informed judgment will result in a fair-value answer that is consistent and helpful to the various information needs of investors and managers.

Fair Value, while imperfect, is the best measurement basis to meet the many and varied needs of investors and managers. Thorough informed judgment is required to prepare supportable fair-value estimates. Ultimately, best practice Fair Value estimates require both art and science, that is, judgment and best practice methodologies.

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1 http://www.privateequityvaluation.com/
2 IPEV Guidelines page 7.

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About the Authors

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In May 2014, Andrew J. Bowden, the Director of the SEC’s Office of Compliance Inspections and Examinations, gave a speech entitled “Spreading Sunshine in Private Equity.” While sounding cheery, the “spreading sunshine” metaphor was an ironic evocation of Justice Brandeis’s famous statement that “sunlight is said to be the best of disinfectants” in response to social and industrial diseases.

Mr. Bowden used his “sunshine” speech to catalog a number of maladies purportedly afflicting the venture capital industry. 1 According to Mr. Bowden, the SEC identified violations of law or material weaknesses with respect to expenses, disclosure of fees, marketing and valuation practices, and the implementation of effective policies and procedures to ensure compliance. Venture capital firms should view Mr. Bowden’s speech as a warning to identify and correct deficiencies before a limited partner complains or the SEC commences an examination.

This article addresses a few of the areas that Mr. Bowden identified, including compliance procedures (here we address compliance with the SEC’s pay to play rules) and effective disclosures relating to fund expenses. These topics are important for all venture capital firms, including firms that are exempt reporting advisers under the venture capital exemption. The SEC has enforcement authority over these issues, regardless of whether a venture capital firm is registered as an investment adviser.

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1 Although Mr. Bowden referred to the “private equity industry” in his speech, we believe that he used this as a catch-all phrase to include the venture capital industry.
Expense-Shifting and Disclosure

According to Mr. Bowden, the SEC identified violations of law or material weaknesses in controls with respect to expenses in over 50% of the firms reviewed by the SEC during examinations. Three specific areas of deficiencies were highlighted: (1) the use of consultants, often referred to as “Operating Partners” in private equity and “Venture Partners” in venture capital, without disclosing that the funds or the portfolio companies rather than the management company pay the consultants; (2) the shifting of expenses from management companies to funds during the course of a fund’s life; and (3) automation of certain processes, which advisers use to pass costs from the management company to the funds.

Even though only a handful of cases have been filed to date, the SEC is actively investigating expense-shifting issues in the venture capital and private equity industries. As the Presence Exam Initiative wraps up, firms should expect an increase in SEC activity in this area.

A. Operating/Venture Partners

“Operating Partners” or “Venture Partners” are frequently promoted to potential investors as an integral part of the investment adviser’s team. From a financial point of view, however, the Operating/Venture Partners are treated as independent consultants or advisers who are compensated by the fund or one or more of the fund’s portfolio companies. From the SEC’s perspective, the concern is that the compensation costs are essentially borne by the fund (and indirectly by the limited partners) while the limited partners may believe incorrectly that these Operating/Venture Partners are employees of the management company and compensated out of the management fee. The key question, therefore, is whether the investment adviser has adequately disclosed this compensation structure for Operating/Venture Partners to investors.

In assessing risks, the first step for a venture capital firm is to evaluate whether it has a Venture Partner program that may raise concerns from the SEC’s perspective.

The SEC seems focused on Operating/Venture Partners with some or all of the following characteristics: (1) they receive a draw or some other form of compensation from an investment fund or portfolio company in addition to, or in lieu of, compensation from the management company; (2) they maintain offices at the investment adviser’s offices; (3) they invest in the manager’s funds on similar terms as other employees; (4) they have the title “partner”; (5) they appear on the manager’s website and other marketing materials as full members of the team; and/or (6) they work as part of the investment team and source deals and work on different transactions.

If a Venture Partner program has some or all of these characteristics, the next question is whether the compensation structure was adequately disclosed to the limited partners. Venture capital firms should examine their offering materials, investor letters, financial statements, and audit reports, and, if they are a registered investment adviser, their Form ADV Part 2A disclosure brochures. If the compensation structure was clearly and adequately disclosed to the limited partners, then it is unlikely that there is cause for further concern or action.

If, however, there are doubts about the adequacy of the disclosure, firms should consider whether to make a follow up disclosure of the program to the limited partners. Firms should also consider whether they can or should take other remedial steps, depending on the potential reaction of LPs.

It is difficult to assess precisely how the SEC will handle these cases, particularly where there was some disclosure around the Operating/Venture Partner program and the compensation structure, but perhaps the disclosure was less than perfect. The SEC has filed only one major case clearly relating to an investment adviser’s efforts to shift employee costs to the funds and portfolio companies, In re Clean Energy Capital, LLC and Scott A. Brittenham, Investment Advisers Act Release No. 3785 (Feb. 25, 2014). Unfortunately, the case is a poor barometer of the SEC’s approach to Operating/Venture Partners because the conduct at issue in the Clean Energy action was particularly egregious. According to the SEC’s complaint, Clean Energy, which served as an investment adviser to 20 different funds, improperly charged to the funds major expenses such as the salaries of the majority of Clean Energy’s employees, executive bonuses, health benefits,
retirement benefits and rent, as well as minor expenses like group photos, checks and letterhead, bottled water, office lunches and charges related to transporting the daughter of Clean Energy’s main portfolio manager to and from school.

The SEC assessed whether Clean Energy had disclosed in the offering materials that certain of these expenses would be borne by the fund, and found that the disclosures were inadequate. Most of the offering documents disclosed only that the funds would be required to pay simply “reasonable partnership expenses related to the acquisition or disposition of securities.” Moreover, several of the funds’ offering materials “expressly state[d] that [Clean Energy] would pay its own management expenses” or that Clean Energy “would pay the compensation of its employees.” In addition, none of these expenses were disclosed in Clean Energy’s Forms ADV or its financial statements.

**B. Shifts of Expenses During a Fund’s Life**

The SEC has initiated a number of actions – even before the conclusion of the SEC’s presence examination program – involving allegations that, during a fund’s life, an adviser had improperly shifted to investors a set of expenses properly charged to the investment adviser. A few examples of these actions include:

**In the Matter of Envision Capital Management, Ltd. and Michael M. Druckman**

Envision Capital Management was an investment adviser to three funds with extensive holdings in real estate loans, and Michael M. Druckman was its owner and officer. As disclosed in each fund’s private offering memorandum, Envision Capital charged monthly fees to the funds. Envision Capital periodically used one fund’s capital to pay the expenses of another fund, without properly disclosing to investors its intent to do so. Envision was charged with disclosure violations. It settled with the SEC, paid a fine, and undertook to review and improve various policies.

**In the Matter of Robert Pinkas**

An additional SEC action that warrants mention in this article addresses a similar situation, in which certain personnel expenses were shifted improperly to the fund. In the Pinkas case, Robert Pinkas had been the target of a previous SEC enforcement action and a parallel district court action relating to a “business development” company he managed. While these actions were pending, Pinkas served as an investment adviser to several private investment funds. Pinkas used assets from one of those funds to cover his legal fees for the prior SEC enforcement action without disclosing this to his investors. Under the fund’s LPA, Pinkas was permitted to use investor funds for legal fees only after he had properly notified investors. Pinkas was alleged to have engaged in misappropriation and misrepresentation of facts in relation to that misappropriation.

The Pinkas case highlights the importance of proper disclosure to investors: the SEC’s enforcement action arose not simply from Pinkas’s attempt to shift fees to investors, but from Pinkas’s failure to properly notify investors of his intent to do so. The Envision action hammers home the same point – the SEC looked closely for evidence that the investment adviser had disclosed its activities to the investor, and found such evidence lacking.

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C. Process Automation

While the SEC has not yet brought any enforcement actions related to process automation, Mr. Bowden emphasized that the costs of added process automation must fall on the investment adviser, whose responsibilities include generating and delivering proper reports, not on the unsuspecting investor. A good rule of thumb in this regard is to be conscious of whether a certain process that has been automated was one previously handled by the investment adviser: if so, it is likely that it should be charged to the management company, rather than the investors’ funds or portfolio companies, unless it has been fully and fairly disclosed.

D. Looking Forward: Improving Disclosures as the Best Defense

Expense shifting is an area of SEC enforcement activity that is still quite new, with very little precedent available to guide funds. One critical trend can be seen across these cases, however: the importance of proper disclosures. In each case, the SEC highlighted the adviser’s failure to properly disclose its activities. In light of Mr. Bowden’s stated concerns, advisers may also find themselves responding to more requests for additional information from prospective or current investors. Strengthening disclosure protocols to investors should help preemptively aid investors in understanding the fund’s financial and cost structure while also limiting an adviser’s exposure to a potential SEC’s enforcement action.

Going forward, a venture capital firm that wishes to implement, or has already implemented, a Venture Partner program should be sure to provide clear and thorough disclosures on the relationship between the Venture Partners and the investment adviser. These disclosures should, ideally, include information about how the Venture Partner is compensated; what expenses will be paid for by the fund; and what expenses will be paid for by a portfolio company. The venture capital firm should also structure its disclosures with an eye to the criteria for an Operating Partner mentioned in the “Sunshine” speech. The marketing materials should note any and all distinctions between the venture capital firm’s employees and their Venture Partners. This will essentially eliminate the “back door” fee that Mr. Bowden feared, as the investors will be well-informed about the nature of these partners’ relationship to the firm as well as the sources of their compensation.

Similarly, proper disclosure of mid-fund-life shifting of expenses, as well as in process automation, also will help obviate Mr. Bowden’s concerns about investor information rights. Providing investors with disclosures of any fees that the investment adviser plans to charge to the funds will help investors exercise their own oversight over the funds’ activities.

Even though a Venture Partner program may be substantively beneficial to an investment fund, and there may well be a defensible business justification for imposing the costs on the investment fund, the best way to avoid the costs and uncertainty of a dispute with the SEC over the business merits is to make a complete disclosure of the program to the limited partners.

Playing by the Pay to Play Rules

The SEC promulgated Rule 206(4)-5 in 2010 to prevent “pay to play” practices by investment advisers seeking to manage state and local government assets. While the fundamental purpose of the Rule is easy to understand, compliance presents a number of challenges. As a general matter, the Rule provides that if an investment adviser, or a “covered associate” of an investment adviser, makes a contribution to certain elected officials or candidates for office, the adviser is prohibited from receiving compensation for investment advisory services from that government entity within two years of the contribution. In addition, under the Rule, advisers and covered associates cannot “coordinate” or “solicit” contributions to officials of government entities to which the adviser provides (or seeks to provide) investment advisory services.
While the Rule has been in effect for several years, it has only recently gained significant attention from an enforcement perspective, and it now appears to be a high priority for the SEC. In June 2014, the SEC issued its first Order enforcing the Rule, censuring an investment adviser (TL Ventures Inc.) and ordering it to pay nearly $300,000 for two contributions (totaling $4,500) by one covered associate. According to its press release announcing the charge, the SEC found that the investment adviser violated the pay to play rules by continuing to receive compensation from two public pension plans within two years after a covered associate made campaign contributions to two political candidates. The SEC found that the political candidates who received the contributions could have had the ability to influence the selection of investment advisers for their state’s respective public pension funds. The investment adviser settled with the SEC, resulting in the Order.

Given its limited scope, the Order is probably best viewed as a signal from the SEC that it intends to enforce the Rule vigorously. The takeaway for investment advisers is that they should re-examine their own policies and practices to ensure strict compliance. That does not mean, however, that investment advisers should make only prospective changes to their policies and practices. Instead, investment advisers who are currently managing public money should retrospectively examine their practices and compliance with the Rule – because the SEC certainly will.

The first question that an investment adviser should ask is: who is covered by the Rule, or more particularly, who is a “covered associate?”

The Rule defines a covered associate as:

(i) Any general partner, managing member or executive officer, or other individual with a similar status or function;

(ii) Any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and

(iii) Any political action committee controlled by the investment adviser or by any person described in paragraphs (f)(2)(i) and (f)(2)(ii) of this section.

Section 275.206(4)-5(f)(2).

Stating the definition is easier than applying it, particularly at the margins (i.e., to people who are not “key persons”) where there is most likely room for disagreement and error. In an implicit recognition that the definition may be vague in some circumstances, the SEC tried to give it further meaning in the Order in TL Ventures case, stating that “covered associates’ are officers and employees of the adviser who have a direct economic stake in the business relationship with the government client.” Putting aside whether that explanation clarifies the definition, it seems to suggest that the SEC is focused on persons who will receive a direct economic benefit from the government entity’s investment in the fund – beyond mere continued employment.

Complicating matters further, the Rule has some retroactive characteristics, meaning that even a “new” covered associate – either by way of a new hire or an internal promotion – may come with baggage. The Rule provides an exception for new covered associates who made a covered contribution more than six (6) months prior to becoming a covered associate – provided that the new covered associate will not be soliciting clients for the adviser. However, if the newly hired or promoted covered associate will be soliciting clients for the adviser, the Rule treats that person’s political contributions the same as existing covered associates, and any covered contributions by that individual – even if made before they were hired or promoted – would trigger the Rule’s two-year “time out” provision as to the adviser.

The first question that an investment adviser should ask is: who is covered by the Rule, or more particularly, who is a “covered associate?”
As a result, investment advisers must not only determine who their covered associates are, they also must evaluate contributions by potential hires, employees being considered for promotion, or anyone else with whom the adviser becomes affiliated if that person may be or may become a “covered associate” under the Rule. Investment advisers would be wise to assume a broad definition of “covered associate” in examining their own personnel – particularly where the personnel may have engaged in political activity. The safest practice, of course, is to consider every person affiliated with the firm who is substantively involved in the firm’s business to be a “covered associate” under the Rule, and to craft the firm’s compliance policies accordingly. Creating ad hoc exceptions for certain firm personnel or persons affiliated with the firm – especially if the reason for doing so is that a certain individual is particularly politically active – will create an additional layer of complexity in dealing with the SEC if the firm’s compliance with the pay to play Rule comes under scrutiny.

Knowing who is a covered associate, however, is only half the battle. Investment advisers must also identify whether a covered associate’s activity constitutes a “contribution” or a “solicitation” under the Rule – and it is not as simple as asking whether someone wrote a check or made a financial contribution. Broadly, a “contribution” is transferring something of value for a political purpose, whereas a “solicitation” is a communication to arrange a contribution or political payment.

The distinction between these activities is critical, as it affects the potential penalties an adviser faces for a violation. An unlawful contribution triggers the two-year time out on providing investment management services for compensation. As in the TL Ventures matter, the SEC may seek disgorgement of an adviser’s fees paid by the government entity for that two-year period (among other penalties). An unlawful solicitation, however, does not trigger the two-year timeout, but may subject the adviser (and the covered associate who solicited a contribution) to civil and criminal penalties.

Even though the distinction between contribution and solicitation is critical, applying the distinction in practice is not straightforward. For example, a contribution concerns a transfer of value, whereas a solicitation concerns mere communication; but a covered associate’s donation of time to solicit contributions (e.g., by organizing political events) may be viewed as a contribution under the Rule if, for example, the adviser
solicited the covered associate’s political activities or the covered associate used the adviser’s resources, such as telephones and office space, to engage in political activity. The proper classification of a covered associate’s activities may turn upon the specific facts presented, and may determine whether the adviser can retain its fees from government clients for the two years following such activities.

Advisers should also note that the Rule is written broadly, and they should assume that it is a strict-liability, prophylactic measure. What advisers or their covered associated intended to do is likely irrelevant: unlike Rule 10b-5, the SEC has taken the position that proving a violation of Rule 206(4)-5 does not require a showing of scienter or quid pro quo. Additionally, whether the violation was “direct” or “indirect” is irrelevant.

In sum, compliance with the pay to play Rule is complex, and there is a dearth of guidance. In addition, there are various state law analogues that have a different scope. Investment advisers whose personnel engage – or have engaged – in any political activities should develop and enforce policies to ensure strict compliance, and review past practices to correct deficiencies.

**Conclusion**

The SEC’s focus on the venture capital industry is intensifying, particularly with respect to compliance and disclosures. The best way for venture capital firms to avoid unwelcome scrutiny is to adopt robust compliance procedures and adhere to them scrupulously.
It’s no secret there are hundreds, if not thousands of small businesses who want to change the world. Entrepreneurs and business owners dream of their big idea improving the way we do business, technology, medical procedures and a million other things. They are focused on reaching their goals, driven in their pursuit of change and deeply passionate about their chosen field. Sometimes there are necessary evils that exist in order to build a great company or take a new innovative product to market. Many will argue that human resources is on that list. But evil or not, human resources is most definitely necessary.

While entrepreneurs are focused on their vision and working to fulfill their dream, they might also be overlooking important human resources issues. Beyond paying bright employees well and filing patent paperwork, there are numerous regulations to follow, forms to turn in and deadlines to meet. Many entrepreneurs are simply not aware of the numerous boxes to check and the potentially devastating consequences that can occur if all the right steps are not taken in the right order and at the proper stage of the business cycle. Obviously, this can be problematic – both for their companies and for the venture capital firms who support them.

Venture capital firms invest a great deal of time and resources researching which organizations to fund and how to maximize returns on investments. Before financially backing an idea, it makes sense to investigate not only the idea, but how the team plans to execute it. This likely includes sitting through countless proposals, listening to pitches and sitting through demonstrations to determine which enterprises are worthwhile partners. Recent NVCA statistics put
2013 total VC investments at more than $29 billion dollars and 2014 is on track to greatly surpass that dollar amount. Large sums of money to support small companies with big ideas.

As an investor, once you’ve done your due diligence and have decided which of the talented and promising companies to financially support, are you certain it was a sound decision? Are you confident that the enterprise is not so focused on their long-range goals that they are unknowingly neglecting important human resources regulations and objectives, potentially undermining all the value you have built?

**Why HR Matters**

By its very nature, HR is generally not a profit center and just doing it correctly will not likely increase the enterprise’s status, visibility, partnerships, funding or customer loyalty. However, the harsh reality is that, if not managed correctly, there are often significant financial implications. Complicated employment issues along with lawsuits and potential financial penalties can tie up a company’s time, money and other resources. Ultimately, if leadership is not paying attention to HR laws, regulations and updates in addition to their goals of perfecting their service or product, then it not only ties up their resources, it also ties up your investment.

It is easy to admire and even envy an enterprise company’s great passion and focus as they are determined that they have that one big thing that will change the world. However, as they are diligently working toward their goals, they may be missing the impact of engaging properly trained employees or unintentionally promoting a workforce that has elements of subtle (or sometimes even blatant) discrimination. Additionally, start-up companies often do not have the internal talent that understands the complexities associated with employee paperwork, state filings or building a benefits platform that is going to attract and retain the best and the brightest. Though that best and brightest talent may help them get their idea to market, a closer look may reveal that their talented team may not have been properly trained on how to handle certain people-related tasks or understand compliance and the intent to mitigate the company’s risks.

If you asked, you might be hard-pressed to find an entrepreneur or executive that can name the numerous legal acronyms that come with running a business or know what forms, rules, deadlines or fees go with each. To throw out just a few; SUTA, FMLA, FSA, HIPPA, ADAAA, FTE, EPLI, WC, ACA, COBRA and ERISA are all important factors to consider in regard to business tasks that encompass human resources, payroll, risk mitigation and employee benefits. Spending time managing through these various complexities keeps them away from their true passion and desired focus, which is the very reason they founded the company in the first place.

Breaking it down to the simplest terms, in the great pursuit of changing the world, start-ups and small businesses are really busy just trying to succeed. Leadership is focused on surviving and thriving and unfortunately, human resources tasks are often done hastily or haphazardly. Perhaps those tasks are being handled by the entrepreneur or have been tacked on to a founding partner’s growing list of responsibilities. In some cases, a company may be a group of friends who divvied up the various business functions or hired an acquaintance to handle what on the surface may appear to be mundane tasks, such as making sure rent and vendors are paid on time as well as handling that necessary evil...HR.

Rapid growth, while obviously often desired and even expected, can also contribute to or even be the cause of human resources issues. Employee issues that were handled informally when the company was a small group of friends can become major problems when additional employees are hired into the company. For example, joking and teasing among founders (who may have already been friends and established a long-term familiarity) may have been standard behavior when it was just them fleshing out new ideas. Late
nights working on their great idea may have become the norm for them over time. However, put in the same situation, a new employee might perceive those very conversations, though perhaps meant to be light hearted and jovial, as contributing toward a hostile work environment. Or maybe those long hours they are now expected to work may make them feel that they are entitled to overtime pay (and you may not be sure that they are not.) If the position descriptions and expectations are not clearly outlined in writing and executed properly, the company could quickly lose their new talent if the roles and responsibilities are not living up to what was discussed in the interview process.

**Put a Plan into Action**

A formal and focused human resources function can help prevent a myriad of HR-related problems. Venture capital firms would be wise to advise their enterprise companies to put a thorough organizational plan in place that includes creating and adhering to an employee handbook and having the proper expertise do a full HR assessment to see where any potential gaps may exist. This can be done either in-house or it can be outsourced if the company does not think they have the time or knowledge necessary to dedicate to doing it correctly. Time is also of the essence. Putting off structuring the plan, developing management’s responsibilities and informing all employees of expectations is a dangerous gamble.

Outsourcing human resources is often a good early point of discussion to have with a company when deciding whether or not to fund their activities. By outsourcing, they are removing the pressure of those tasks and in turn, have more time and energy to focus on their core strengths and talents. This focus on their core competencies could potentially mean getting an idea to market faster, thereby speeding up the revenue stream for both the company and its investors. An outsourced HR partner can assess the situation objectively and make suggestions based on real needs and not just the perceived environment.

While a funded company may balk at using a portion of its hard-earned income to pay someone else to handle seemingly mundane tasks that they think are under control, the cost involved with having certified professionals handle human resources, benefits administration, payroll, risk management and related tasks pales in comparison to potential fees, fines and judgments against the funded company if one or more aspect is not managed correctly. Additionally, certain types of HR outsourcing, such as working with a Professional Employer Organization (PEO) will help mitigate the company’s risks by sharing or, in some cases, transferring the associated liability of employment.

**Not Having an HR Strategy Could Cost You**

There is real money to be lost when this function is not handled properly. In 2013, the Equal Employment Opportunity Commission (EEOC) received 93,727 charges of harassment and discrimination and this large number does not include the employee complaints and demand letters that were handled internally by companies or filed with other
By working with a partner who will help structure and offer recommended employee training and development, some of which is often required by law for supervisors or new hires, a company can show that they have done their due diligence to provide a safe workplace and potentially prevent unlawful behaviors.

administrative agencies. Settlements in employee litigation cases can range from tens of thousands well into the millions of dollars and there is no guarantee on a cap. National corporations may be able to afford legal counsel and payment of the fines if the case is found against them, but there are few small businesses or start-ups who could bounce back from that kind of judgment.

As an example, after a June 2014 hearing, A.C. Widenhouse, a North Carolina-based trucking company, will pay $243,509 in compensatory and punitive damages, back pay and pre-judgment interest because the company was found guilty of racial harassment and discrimination of two workers. The court also required the company to implement a written anti-discrimination policy, conduct training on Title VII for all employees and owners involved in company operations, post the anti-discrimination policy and a notice to employees regarding the lawsuit, and provide the EEOC with periodic reports regarding complaints about racial harassment.

An EEOC complaint can be expensive, time-consuming and embarrassing – not just for the enterprise or owner, but also for VC firms, other investors and partners. And, due to the all-knowing power of the internet, judgments are no longer shortly relegated to yesterday’s news. Many judgments and summaries are posted on the EEOC website, easily searchable by potential employees or other parties interested in doing business with the company. (After their website, the Widenhouse judgment is both the second and third result found in a Google search of the company name.)

By working with a partner who will help structure and offer recommended employee training and development, some of which is often required by law for supervisors or new hires, a company can show that they have done their due diligence to provide a safe workplace and potentially prevent unlawful behaviors. They can also avoid seemingly small mistakes that can quickly add up to large problems. With the expertise of a trusted outsourced business partner, an enterprise has a stronger foundation to know what interview questions are off-limits due to EEOC regulations, what protected leave includes and a structured plan for staying current and compliant on federal and state (and in some cases, city) laws and policies.

In addition to EEOC regulations and guidance, there are many Department of Labor regulations to consider. It may sound minor, but does the enterprise company know which posters they are required by law to display for employees? Do they know what employee records they are required to keep and for how long? These seemingly small details take time to research and can quickly add up to large headaches if not handled correctly, whether they have two employees or 250 employees.

And as if that wasn’t enough to worry about, now businesses have to navigate through the Affordable Care Act (ACA). A small business owner could spend days going over the many ever-changing provisions buried within the ACA that include penalties for certain companies if requirements are not met. Figuring out what regulations apply to them and how to calculate their employee numbers and rates can take an enormous amount of time and a deeper level of knowledge and expertise of the ever-changing law than most entrepreneurs, or even some average human resource professionals, possess.
The Department of Homeland Security has also promised to impose harsh fines on businesses found to have I-9 reporting violations. Staying on top of those can become a full-time job, pulling entrepreneurs away from their core competencies and away from revenue-generating activities. There is little value or reward to having this function managed by a founder or executive.

You Are Not in It Alone

An outsourced partner can provide experts in human resources, health benefits management including ACA regulations, workers’ compensation and risk mitigation, to name just a few. By outsourcing, the company has access to talented, experienced, degreed professionals who spend their careers concentrating on the ins and outs of employment law so that entrepreneurs and small business owners can instead focus on their own passions and areas of expertise.

Partners such as PEOs can help the funded company avoid becoming a statistic by examining business practices and helping to establish procedures for payroll, management of taxes and unemployment insurance payments, benefits administration and a policy and procedure handbook that includes information for employees such as terms of employment, time off policies, ethical standards, performance management, termination, training, workplace health and safety and more as needed depending on the industry and work environment. Additionally, arguably the most critical component of HR is to help support the executive team and founders as they drive a culture of engaged employees who are focused on building a successful venture. Solid outside expertise can put together focused human capital plans for the business that truly align their people practices with their short-term goals and long-term strategic objectives.

VC firms can recommend that enterprises work with a partner they currently use or instruct the company’s management team or board of directors to research and find their own solution. The enterprise should not be worried that hiring an outside partner to handle these tasks would eliminate a job within their organization. Even with an outsourcing agreement in place, there are still plenty of employee-related tasks to be handled at the company level and that on-site person will still be a valuable resource for co-workers.
who have any concerns about the workplace. The outside partner will likely work closely with designated contacts to develop policies and procedures that best fit the organization and will coordinate all regulatory activities with those designated by the organization.

Moving beyond ensuring the company is following laws and regulations and freeing up time to focus on original goals, an outsourced partner can also help an enterprise attract and retain the top talent in their field. In some cases, because of the large number of employees they service, PEOs are able to provide access to more options or better health benefits and retirement plans than the company would be able to access on their own. This improvement allows the company to have a more competitive benefits offering and can greatly increase the total employee compensation package, thereby also increasing the likelihood of employees choosing to accept an offer and staying with the company for the long-term.

The outsourced team can also advise about what background checks should be utilized and walk companies through the entire hiring process including interview planning and questions, offer letters, guidance around potential onboarding agreements (such as confidentiality agreements or arbitration agreements, etc.) and other nuances of the onboarding process. They can also suggest implementing programs to help ensure a smooth transition into the workplace, which can greatly affect the new hire’s attitude about their job and get them quickly acclimated to the company’s culture and mission.

Additional services such as web-based career training for employees, assistance on finding qualified talent in their field and cloud-based options to streamline expenses and approvals processes are just a few of the many options that partners can provide to enterprises. Employee management options are available through partners that the company may not have considered, such as guidance through the employee review process and ways to foster and increase team development. These additional services can also help to develop and enhance the culture of the organization which can, in turn, improve productivity and profitability.

To both venture capital firms and their portfolio companies, good human resources practices make good business sense. Unfortunately, focus, passion and drive aren’t enough to meet all the business and legal requirements, but an outsourced solution may be what a funded company and its leadership needs to enable them to fully realize their potential and grow a successful business.

**About the Author**

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About the Innovation@50+ initiative
The Innovation@50+TM initiative aims to spark entrepreneurial activity across public and private sectors. Anchored by the AARP social mission – to enhance the quality of life for all as we age – the initiative enlists the expertise of visionary thinkers, entrepreneurs, the investment community, industry and not-for-profits to spur innovation to meet the needs and wants of people over 50.

On the ground, the initiative catalyzes research and helps shape a marketplace ethos by promoting core, unifying principles such as “design for all.” It stimulates new business models that reflect the broad transformation in how the 50-plus life is being re-imagined. Lastly, the initiative prepares 50-plus people to communicate with, access, engage and thrive in a new “longevity economy.”

For more information please visit: www.aarp.org/innovation50plus

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Headquartered in New York since 1875, the firm has offices in Beijing, Boca Raton, Boston, Chicago, Hong Kong, London, Los Angeles, New Orleans, Newark, Paris, São Paulo and Washington, D.C.

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